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95th Congress
2d Session

COMMITTEE PRINT

TAX EXPENDITURES

Relationships to Spending Programs and Background Material on Individual Provisions

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

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LETTER OF TRANSMITTAL

To the Members of the Committee on the Budget:

The Congressional Budget and Impoundment Control Act of 1974 requires that the Budget Committees and the Congress examine tax expenditures as part of overall Federal budgetary policy. This requirement stems from a recognition that numerous provisions of Federal tax law confer benefits on some individuals and institutions that are comparable to direct Federal spending, but that these tax law benefits seldom are reviewed, in comparison with direct spending programs.

The first part of this Committee print updates basic background information concerning tax expenditures first published by the Budget Committee in March 1976. This information is provided in a series of summaries which describe the operation and impact of each tax expenditure; indicate the authorization and rationale for their enactment and perpetuation; estimate both the revenue loss attributable to each provision and, where provisions affect individual taxpayers directly, the percentage distribution by expanded gross income class of the tax savings conferred by the provision; and cite selected bibliography for each provision.

The second part of this Committee print compares 17 groups of tax expenditures to major spending programs with related or similar purposes. These comparisons analyze diverse areas of Federal policy including, for example, retirement programs, health policy, export incentives, military manpower costs, and general purpose fiscal assistance programs. These analyses indicate the need for policymakers to coordinate both tax expenditure and direct spending programs affecting the same policy areas when these areas are the subject of legislative consideration.

Failure to take tax expenditures into account in the budget process would be to overlook significant segments of Federal policy. They should be given particularly thorough scrutiny because, as this volume indicates, tax expenditures are generally enacted as permanent legislation and thus are comparable to continuing direct spending entitlement programs, often with increasing annual revenue losses.

This volume was prepared jointly by the Budget Committee staff, the Congressional Budget Office, the Congressional Research Service, and the General Accounting Office.

Nothing in this volume should be interpreted as representing the views or recommendations of the Budget Committee or any of its individual members.

Sincerely,

Henry Bellmon,
Ranking Minority Member.

Edmund S. Muskie,
Chairman.

PART I

Compendium of Background Material on Individual Tax Expenditure Provisions

INTRODUCTION

The first part of this compendium gathers basic information concerning 84 Federal income tax provisions currently treated as tax expenditures. These provisions are the same as those listed in *Tax Expenditure Budgets* prepared for FY 1979 by the Office of Management and Budget, the Joint Tax Committee, and the Congressional Budget Office. With respect to each of these tax expenditures, this compendium provides:

An estimate of the Federal revenue loss associated with the provision for individual and corporate taxpayers, for fiscal years 1978, 1979, and 1980;

The legal authorization for the provision (e.g., Internal Revenue Code section, Treasury Department regulation, or Treasury ruling);

A description of the tax expenditure, including an example of its operation where this is useful;

A brief analysis of the impact of the provision;

An estimate, where applicable, of the percentage distribution—by expanded gross income class—of the individual income tax saving resulting from the provision;

A brief statement of the rationale for the adoption of the tax expenditure where it is known, including relevant legislative history; and

References to selected bibliography.

The information presented for each of these tax expenditures is not intended to be exhaustive or definitive. Rather, it is intended to provide an introductory understanding of the nature, effect, and background of each of these provisions. Good starting points for further research on each item are listed in the selected bibliography following each provision.

Defining Tax Expenditures

Tax expenditures are revenue losses resulting from Federal tax provisions that grant special tax relief designed to encourage certain kinds of behavior by taxpayers or to aid taxpayers in special circumstances. These provisions may, in effect, be viewed as the equivalent of a simultaneous collection of revenue and a direct budget outlay of an equal amount to the beneficiary taxpayer.

Section 3(a)(3) of the Congressional Budget and Impoundment Control Act of 1974 specifically defines tax expenditures as:

> . . . those revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability; . . . .

In the legislative history of the Congressional Budget Act, provisions classified as tax expenditures are contrasted with those provisions

which are part of the "normal structure" of the individual and corporate income tax necessary to collect government revenues.

The concept of tax expenditures is relatively new, having been developed over only the past decade. Tax expenditure budgets which list the estimated annual revenue losses associated with each tax expenditure first were required to be published in 1975 as part of the Administration budget for FY 1976, and have been required to be published by the Budget Committees since 1976. The tax expenditure concept is still being refined, and therefore the classification of certain provisions as tax expenditures continues to be discussed. Nevertheless, there is widespread agreement for the treatment as tax expenditures of most of the provisions included in this compendium.[1]

The listing of a provision as a tax expenditure in no way implies any judgment about its desirability or effectiveness relative to other tax or nontax provisions that provide benefits to specific classes of individuals and corporations. Rather, the listing of tax expenditures, taken in conjunction with the listing of direct spending programs, is intended to allow Congress to scrutinize all Federal programs—both nontax and tax—when it develops its annual budget. Only if tax expenditures are included will Congressional budget decisions take into account the full spectrum of Federal programs.

Because any qualified taxpayer may reduce tax liability through use of a tax expenditure, such provisions are comparable to entitlement programs under which benefits are paid to all eligible persons. Since tax expenditures are generally enacted as permanent legislation, it is important that, as entitlement programs, they be given thorough periodic consideration to see whether they are efficiently meeting the national needs and goals that were the reasons for their initial establishment.

Major Types of Tax Expenditures

Tax expenditures may take any of the following forms: (1) exclusions, exemptions, and deductions, which reduce taxable income; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.[2]

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion from tax of interest income from State and local bonds saves $50 for every $100 of interest for the taxpayer in the 50 percent tax bracket, whereas the savings for the taxpayer in the 25 percent bracket is only $25. Similarly, the extra exemption for persons age 65 or over and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50 percent bracket as to one in the 25 percent bracket.

A tax credit is subtracted directly from the tax liability that would otherwise be due; thus the amount of tax reduction is the amount of the credit—which does not depend on the marginal tax rate.

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[1] For a discussion of some of the conceptual problems involved in defining tax expenditures, see *The Budget of the United States Government, Fiscal Year 1979*, "Special Analysis G," pp. 149-153.

[2] See Appendix A for further analysis of these types of tax expenditures.

The numerous tax expenditures that take the form of exclusions, deductions, and exemptions are relatively more valuable to upper than to lower or middle income individuals. However, this fact should be viewed in the context of recent substantial increases in the standard deduction, which provide more tax saving for certain low-middle income taxpayers than itemized deductions, thus reducing the number of them who itemize.

Moreover, even though some tax expenditures may provide most of their tax relief to those with high taxable incomes, this may be the consequence of overriding economic considerations. For example, tax expenditures directed toward capital formation may deliberately benefit savers who are primarily higher income taxpayers.

Estimating Tax Expenditures

The estimated revenue losses for all the listed tax expenditures are based upon work done by the staffs of the Treasury Department and the Joint Committee on Taxation.[3] The estimates are identical to those that appear for the same provisions in the Administration's FY 1979 tax expenditure budget.[4]

In calculating the revenue loss from each tax expenditure, it is assumed that only the provision in question is deleted and that all other aspects of the tax system remain the same. In using the tax expenditure estimates, several points should be noted.

First, in some cases, if two or more items were eliminated, the combination of changes would probably produce a lesser or greater revenue effect than the sum of the amounts shown for the individual items.

Second, the amounts shown for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment and consumption patterns or on any other aspects of individual taxpayer behavior, general economic activity, or decisions regarding other Federal budget outlays or receipts.

Finally, the revenue effect of new tax expenditure items added to the tax law may not be fully felt for several years. As a result, the eventual annual cost of some provisions is not fully reflected until some time after enactment. Similarly, if items now in the law were eliminated, it is unlikely that the full revenue effects would be immediately realized.

However, these tax expenditure estimating considerations are similar to estimating considerations involving entitlement programs. Like tax expenditures, annual budget estimates for each transfer and income security program are computed separately. However, if one program, such as veterans' pensions, were either terminated or increased, this would affect the level of payments under other programs, such as welfare payments. Also, like tax expenditure estimates, the elimination or curtailment of a spending program, such as military spending or unemployment benefits, would have substantial effects on consumption patterns and economic activity that would directly affect the levels of other spending programs. Finally, like tax expenditures, the budgetary effect of terminating certain entitlement programs would not be

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[3] The revenue estimates are based on the tax code as of Dec. 31, 1977.

[4] *The Budget of the United States Government, Fiscal Year 1979*, "Special Analysis G," pp. 158-160.

fully reflected until several years later because the termination of benefits is usually only for new recipients with persons already receiving benefits continued under "grandfather" provisions.

Expanded Gross Income Class Distributions

Distributions of the tax benefits by "expanded gross income" class are given for almost all tax expenditures providing direct tax relief to individual taxpayers. These distribution figures show the portion of the total estimated revenue loss attributed to each tax expenditure that goes to all taxpayers with expanded gross income falling within the boundaries of the respective income classes. No distribution to individual income classes is made of the tax expenditure benefits provided directly to corporations, since to do so would require unsubstantiated assumptions concerning the ultimate beneficiaries of these corporate tax relief provisions.

Expanded gross income is a broader concept than the "adjusted gross income" concept that appears on income tax returns. In addition to "adjusted gross income," it includes the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax. However, it excludes the deduction of investment interest up to the amount of investment income. It therefore comes closer to real economic income than does adjusted gross income.

Individual income tax returns falling within each expanded gross income class for calendar 1977 were estimated by the Treasury Department as follows:

Expanded income class ($000)	Thousands of returns filed	Percent of returns in each class
0 to 5	25,474	29.0
5 to 10	20,109	22.9
10 to 15	16,106	18.3
15 to 20	11,824	13.4
20 to 30	9,907	11.3
30 to 50	3,347	3.8
50 to 100	985	1.1
100 to 200	198	0.2
200 and over	49	0.1
Total	87,998	

The tax expenditure distributions by expanded gross income class are taken from a study done by the Treasury Department in early 1978 at the request of Chairman Edmund S. Muskie, and are the most recent estimates of this type. These distributions indicate in a general way whether specific tax expenditures provide tax benefits largely to lower, middle, or high income taxpayers.

Order of Presentation

The tax expenditures are presented in an order which generally parallels the budget functional categories used in the Congressional budget, i.e., tax expenditures related to "national defense" are listed first, and those related to "international affairs" are listed next. In a

few instances, two or three closely related tax expenditures derived from the same Internal Revenue Code provision have been combined in a single summary to avoid repetitive references even though the tax expenditures are related to different functional categories. This parallel format is consistent with the requirement of Section 301(d)(6) of the Budget Act, which requires the tax expenditure budgets published by the Budget Committees as parts of their April 15 reports to present the estimated levels of tax expenditures "by major functional categories."

Rationale

The material on each tax expenditure contains a brief statement of the rationale for the adoption of the tax expenditure where it is known. These rationales are the principal ones which were publicly given at the time the provisions were enacted.

Further Comment

In the case of a number of tax expenditures, additional information is provided under the heading "Further Comment." It is material which either focuses attention on some of the principal issues related to a provision or describes recent legislative proposals to amend a provision. This is material that does not fit within the other elements of the format of the compendium—either in the "Description," "Impact," or "Rationale" sections. As the examples which are provided in the descriptions of only some of the tax expenditures, the "Further Comment" sections are included only where they were deemed to be useful. Providing information under the "Further Comment" sections for only certain tax expenditures in no way implies any judgment about these provisions.

EXCLUSION OF BENEFITS AND ALLOWANCES TO ARMED FORCES PERSONNEL

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1,470	------	1,470
1979	1,370	------	1,370
1978	1,260	------	1,260

Authorization

Sections 112 and 113,[1] Regulation §1.61–2,[2] and court decisions.

Description

Military personnel are not taxed on a variety of in-kind benefits and cash payments given in lieu of such benefits. These tax-free benefits include quarters and meals or—alternatively—cash allowances for these purposes, certain combat pay, and a number of less significant items.

Impact

All military personnel receive one or more of these benefits which are generally greater in the higher pay brackets. The amount of tax relief increases with the individual's tax bracket, and therefore depends on a variety of factors unrelated to the taxpayer's military pay, such as other income including income from a spouse, and the amount of itemized deductions. Therefore, the exclusion of these benefits from taxation alters the distribution of net pay to service personnel.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	52.5
10 to 20	37.0
20 to 30	5.0
30 to 50	4.1
50 and over	1.4

[1] The word "Section" denotes a section of the Internal Revenue Code of 1954 as amended unless otherwise noted.
[2] Reference to "regulations" are to Income Tax Regulations unless otherwise noted.

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Rationale

Although the principle of exemption of armed forces benefits and allowances appeared early in the history of the income tax, it has evolved through subsequent specific statutes, regulations, revenue rulings, and court decisions. For some benefits, the rationale was a specific desire to reduce tax burdens of military personnel during wartime (as in the use of combat pay provisions); other preferences were apparently based on the belief that certain types of benefits were not strictly compensatory but rather intrinsic elements in the military structure.

Further Comment

Administrative difficulties and complications could be encountered in taxing some military benefits and allowances that are tax exempt; for example, it could be difficult to value meals and lodging when the option to receive cash is not available. However, eliminating the exclusions and adjusting pay scales accordingly might simplify decision-making about military pay levels and make "actual" salary more apparent to recipients.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle*, The Brookings Institution, Washington, D.C., April 1975.

EXCLUSION OF MILITARY DISABILITY PENSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	130	------	130
1979	120	------	120
1978	115	------	115

Authorization

Section 104(a)(4) and 104(b).

Description

Service personnel who joined the armed forces on or before September 24, 1975, and have at least a 30-percent disability or at least 20 years of service and any amount of disability may draw retirement pay from the Department of Defense based on either percentage of disability or years of service. If the chosen pension is less than 50 percent of the basic pay, it will be raised to 50 percent during the first 5 years of retirement. Pay based on percentage of disability is fully excluded from gross income under section 104. If pay is based on years of service, only the portion that would have been paid on the basis of disability is excluded from income.

Members of the armed forces who join the service after September 24, 1975, are allowed to exclude military disability payments only if the payments are directly attributable to combat-related injuries. The term "combat-related injury" means personal injury or sickness which is incurred (1) as a direct result of armed conflict, (2) while engaged in extra-hazardous service, (3) under conditions simulating war, or which is (4) caused by an instrumentality of war.

Disability payments administered by the Veterans Administration are excluded from gross income. These payments are based on degree of disability rather than length of service. A serviceman who joins the armed forces after September 24, 1975, retires on disability, and receives taxable disability payments from the Department of Defense, is allowed to exclude from income an amount equivalent to what he would have been entitled to if his payments had been received from the Veterans Administration.

Impact

Disability payments that are exempt from tax provide more net income than taxable benefits at the same level. The tax benefit of this provision increases as the pensioner's marginal tax rate increases. Thus, the after-tax pension benefits increase as a percentage of active duty pay as the individual's tax bracket increases.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	47. 6
10 to 20	38. 1
20 to 30	9. 5
30 to 50	3. 8
50 and over	0. 9

Rationale

Prior to 1976, military personnel could exclude from income pensions for personal injuries paid by the Department of Defense. The rationale was not clear for the exclusion, which was adopted during World War II in 1942. In limiting the exclusion, in 1976, Congress sought to eliminate abuses by armed forces personnel who were classified as disabled shortly before becoming eligible for retirement in order to obtain tax exempt treatment for their pension benefits. After retiring from military service, most of these individuals would earn income from other employment while receiving tax-free military pensions. Since present armed forces personnel may have joined or continued their service because of the expectation of tax exempt disability benefits, Congress deemed it equitable to limit changes in the tax treatment of disability payments to future personnel.

Selected Bibliography

Binkin, Martin. *The Military Pay Muddle*, The Brookings Institution, Washington, D.C., April 1975.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 129–31.

EXCLUSION OF CERTAIN INCOME EARNED ABROAD BY U.S. CITIZENS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	415	------	415
1979	385	------	385
1978	360	------	360

Authorization

Sections 911–912.

Description

U.S. citizens are generally taxable on their worldwide income. However, under the law existing prior to the Tax Reform Act of 1976, up to $20,000 of foreign earned income (largely salary income) may be excluded annually from income under section 911 by a citizen who (1) is a bona fide resident of a foreign country for an uninterrupted period that includes a taxable year, or (2) has been present in a foreign country for 510 days out of 18 consecutive months. The annual exclusion is raised to $25,000 for an individual who has been a bona fide resident of a foreign country for at least 3 consecutive years. A qualifying individual can claim a foreign tax credit for foreign income taxes paid on the income subject to the exclusion as well as any additional income.

The Tax Reform Act of 1976 made major changes in the exclusion. Under these provisions, up to $15,000 of foreign earned income generally may be excluded annually from income under section 911 by a qualifying individual who (1) is a bona fide resident of a foreign country for an uninterrupted period that includes a taxable year, or (2) has been present in a foreign country for 510 days out of 18 consecutive months. The limit is $20,000 for employees of charitable organizations. The exclusion is achieved by an "exclusion with progression" method where the U.S. tax liability is the difference between tax liability on total income and tax liability on the excluded amount with itemized deductions allocated between those amounts. A taxpayer may take a credit against U.S. income tax liability for foreign income taxes paid, but these creditable taxes do not include the foreign taxes paid on the excluded income.

Congress delayed the implementation of the 1976 Tax Reform Act changes to apply first to taxable years beginning in 1977. It is likely the revisions made in the 1976 Act will be delayed again, and that they will never actually come into effect. However, since the Code now provides that the 1976 changes will be in effect in 1977 and the following

years, the estimated revenue losses indicated above for sections 911 and 912 are based upon the 1976 law.

Section 911 does not apply to salaries received from the U.S. Government. However, section 912 exempts from tax certain allowances that are received by Federal civilian employees working abroad and in Alaska and Hawaii. The principal exempt allowances are for high local living costs, education, and housing.

Examples

Pre-1976 Law. Assume a married taxpayer has $40,000 of income, $10,000 of itemized deductions, and qualifies for the $20,000 exclusion under the pre-1976 law. The tax before any foreign tax credit would be computed by subtracting from the $40,000, the $20,000 exclusion plus the $10,000 of itemized deductions, plus $1,500 for personal exemptions. This would result in taxable income of $8,500 and tax liability of $1,490. Without the exclusion the tax liability would have been the tax on $28,500 ($40,000 minus $10,000 and $1,500), which is $7,377. Thus, the provision would result in a tax saving of $5,887.

1976 Act. Under the 1976 Act rules, the taxpayer calculates the tax liability without any exclusion, which from the previous example is $7,377. This amount is reduced by the tax on the excluded $15,000 less a pro rata part of the itemized deductions. Thus, the $15,000 exclusion must be reduced by 15/40 of the $10,000 of itemized deductions, leaving $11,250. The tax on that amount is $2,095. This $2,095 is subtracted from the total tax of $7,377, leaving a tax liability of $5,282.

Impact

Some U.S. citizens living abroad pay no income taxes to the countries in which they reside. The pre-1976 Tax Reform Act version of section 911 allows their income up to the appropriate ceiling to be free from United States tax as well.

In cases where U.S. citizens pay foreign income taxes, those taxes, including the taxes paid on the income excluded from taxation under this section, can be credited against any U.S. tax liability that would otherwise exist on other foreign income: earned income above the $20,000 or $25,000 excludable limits and investment income. This allows U.S. taxpayers to offset all the foreign tax—including that paid on the amount of excluded income—against U.S. tax that would otherwise be due on the income in excess of the excluded amount. Thus, the combination of the exclusion and the foreign tax credit can result in levels of income actually exempt from U.S. tax in excess of the stated limits.

The value of the exclusion is the difference between the tax savings and the amount of foreign tax credit which would have been claimed on the excluded amount in the absence of the exclusion. This difference is the greatest, and thus the exclusion has the greatest value, for taxpayers living in those countries where tax rates on the excludable portion are nonexistent or much lower than the U.S. rate. Those countries with substantial numbers of U.S. employees which tend to have lower tax rates include Iran, Singapore, Venezuela, Saudi Arabia, Switzerland, the Philippines, and the Marshall Islands.

In addition to the U.S. citizens who directly claim the benefits from this favorable treatment on their tax returns, overseas employers

also benefit to the extent that salary levels are lower because of the exclusion. In fact, many U.S. firms follow a practice of "tax protection," under which employees' salaries are set at levels to give them the same after-tax salary they would receive in the United States. When this practice is followed, all the direct benefits of section 911 accrue to the employers rather than the employees. U.S. corporations that bid on overseas construction projects assert that the salary savings make them more competitive with foreign bidders, some of the employees of which also enjoy similar tax benefits under the laws of their home countries.

The Treasury Department has estimated that in 1975, approximately 100,000 civilian government employees received one or more allowances that are excluded from income under section 912. Approximately 40,000 of these persons were employed in foreign countries, about 20,000 in U.S. territories, and about 40,000 in Alaska and Hawaii. Roughly 60 percent of the total were civilian employees of the Department of Defense.

The value of the section 912 exemption for allowances received by Federal civilian employees working abroad increases with the recipient's tax bracket. The value therefore depends on a variety of factors including the level of the recipient's Federal salary, the extent of his other income, and the amount of his itemized deductions.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	7.3
10 to 20	12.5
20 to 30	18.7
30 to 50	32.1
50 and over	29.4

Rationale

A less restrictive form of section 911 was first enacted in 1926 to encourage foreign trade. After World War II, the exclusion was justified as part of the Marshall Plan to encourage persons with technical knowledge to work abroad. Although the provision was revised on several occasions, dollar limitations were first enacted in 1953 at $20,000 and $35,000. The latter figure was reduced to $25,000 in 1964.

The exemption for civilian Federal employee overseas allowances was enacted in 1943. The principal rationale was to provide additional compensation for these employees, who were performing vital wartime services.

Further Comment

After enactment of the Tax Reform Act of 1976, substantial controversy developed about the 1976 revisions. Congress acted to delay the application of the changes from 1976 to 1977. Congress is now considering several different proposals to liberalize the provisions enacted in 1976, and, as indicated previously, it appears unlikely that the revisions made in the 1976 Act will ever apply. The proposals now under consideration include a series of special deductions for

cost of living, housing, and educational expenses, as well as combinations of special deductions and flat exclusions.

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DEFERRAL OF INCOME OF DOMESTIC INTERNATIONAL SALES CORPORATIONS (DISC)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	1, 525	1, 525
1979	------	1, 335	1, 335
1978	------	1, 135	1, 135

Authorization

Sections 991–997.

Description

A U.S. corporation will qualify as a DISC (Domestic International Sales Corporation) if at least 95 percent of its assets are related to export functions, and if at least 95 percent of its gross receipts stem from export sale or lease transactions.

DISC's typically are wholly owned subsidiary corporations through which parent corporations channel their export sales. DISC's are not themselves subject to corporate income tax, but their parent corporations are taxed on the DISC income when it is distributed or attributed to them.

The tax savings from using a DISC result principally from two interrelated aspects of the tax law: (1) the allocation rules that allow at least half of the total combined profit of the parent and DISC from export sales to be attributed to the DISC; and (2) the potentially permanent deferral which is allowed on half of the DISC profits attributable to exports exceeding a base level. This level is 67 percent of average export receipts during a prior 4-year base period. Through 1979, the base period is 1972–75. Beginning in 1980, the base period will move up 1 year each year, so that the base period in 1980 will be 1973–76, in 1981 will be 1974–77, and so forth. This incremental rule does not apply to DISC's with income of $100,000 or less. This incremental rule exemption is phased out over the $100,000 to $150,000 income range.

The allocation rules provide that a DISC is deemed to have earned either: (1) 50 percent of the combined taxable income of the parent corporation and DISC from export sales or, (2) 4 percent of the gross receipts from export sales, whichever is greater. The 50 percent allocation is used much more frequently. The rules for allocating DISC profits are much more favorable than the otherwise applicable tax law standard (section 482), which allocates profits between two corporations under the same control as if transactions between them occurred at an arm's length price. Generally, if the section 482 rule were applied

to DISC's, only a relatively small, or no sales commission would be allocated to the DISC, while the proportionately larger profits from production would go to the parent corporation.

The deferral of tax continues as long as the undistributed DISC income is invested in qualified assets; the duration may be indefinite, and in such cases constitutes the practical equivalent of a permanent tax exemption. The income allocable to a DISC that is not eligible for deferral is either actually or deemed to be distributed annually to its parent corporation.

Certain exports are not eligible for DISC treatment. These include oil, gas, hard minerals, and products subject to export control under the Export Administration Act of 1969. DISC deferral on exported military goods is limited to half the amount which would otherwise be allowed.

Example

A company formed a DISC in 1974, and sold $8,000,000 of exports in that year and $10,000,000 in 1975. Its sales in 1978 are $10,000,000, with total costs of $8,000,000 and pre-tax income of $2,000,000. The allocation rule attributes 50 percent of the $2,000,000 total net profit in 1978 to the DISC and 50 percent to the parent firm. Of the $1,000,000 allocated to the DISC, one-half, or $500,000 is potentially eligible for deferral before the incremental rule is applied. Average exports for 1972–75 are $4,500,000 ($8,000,000 plus $10,000,000 divided by 4, with non-DISC years counted as zero); 67 percent of this amount is roughly $3,000,000. Under the incremental rule, therefore, 70 percent ($10,000,000 minus $3,000,000/$10,000,000) of the DISC income is eligible for deferral. Therefore $350,000 (0.70×$500,000) benefits from deferral reducing tax liability by $168,000 (0.48×$350,000). This tax saving reduces the tax rate by 8.4 percentage points ($168,000/$2,000,000), reducing the effective tax rate on export income from the statutory 48 percent to 39.6 percent. If the incremental rules had not been applicable, the effective tax rate would have been 36 percent.

Impact

Apart from the incremental rule, the provision reduces the marginal tax rate on most DISC related export income to 36 percent (and to 24 percent in the relatively fewer cases where the total profit on export sales of the DISC and its parent is no more than 4 percent of gross export receipts).

The incremental rule reduces these benefits for companies that do not experience increasing exports, and affects either less substantially or not at all rapidly growing exporters (whose relatively smaller base would be advantageous), new DISC's, and small exporters. The incremental rule was designed to provide more stimulus to exports at a lower cost because the export incentive is aimed at marginal exports. However, the Treasury Department has indicated that the incremental rule reduces the incentive effect with respect to additional exports as well by 40 percent since the exporter must take into account the fact that additional exports now will increase the export base and reduce future DISC benefits.

Whether U.S. exporters reduce export prices in response to reduced effective tax rates is unclear. To the extent they do, foreign purchasers as well as domestic exporters would be subsidized.

According to the Treasury Department, the overall impact of DISC in stimulating exports has been small in comparison to its annual revenue cost. Over the long run, the Treasury contends that adjustments in exchange rates tend to offset any effects the DISC law may have on the balance of trade. U.S. exports have increased dramatically since the DISC provisions were added, but the increase is said to be primarily due to the devaluation of the dollar and worldwide inflation.

On the other hand, many U.S. companies which utilize these provisions argue that DISC should be retained because in their view: (1) the law has substantially increased exports which, in turn, have increased U.S. employment levels; and (2) U.S. industry can remain competitive only if the United States provides subsidies to offset the variety of export promotion devices employed by other countries.

The Treasury Department study cited below in the bibliography reported that for DISC year 1976 before the incremental rule generally became effective, 65 percent of the net income of the 4,822 DISC's with corporate owners for which asset size data were available accrued to 367 companies with gross assets in excess of $250 million.

Rationale

Originally adopted as part of the Revenue Act of 1971, the DISC concept was intended to stimulate exports and enhance the attractiveness of domestic manufacturing vis-a-vis manufacturing through foreign subsidiaries. Restrictions on the benefits for natural resource products and scarce products were adopted in the Tax Reduction Act of 1975. The incremental rule adopted in the Tax Reform Act of 1976 was designed to continue to provide stimulus to exports with a smaller revenue loss.

Further Comment

The DISC provisions have been the subject of some international concern. The European Economic Community lodged a formal complaint under GATT (General Agreement on Tariffs and Trade) in July 1972, arguing that the DISC provision violated GATT rules prohibiting tax subsidies for exports. In 1973, the United States also brought complaints against France, Belgium, and the Netherlands against their tax practices. The panels appointed to consider these questions concluded in 1976 that there was a *prima facie* case for all of these complaints. The United States has recommended adoption of all four panel reports, while the European countries expressed reservations. None of the reports has been adopted to date.

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DEFERRAL OF INCOME OF CONTROLLED FOREIGN CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	720	720
1979	------	665	665
1978	------	615	615

Authorization

Sections 11(f), 882 and 951–964.

Description

A U.S. corporate parent of a foreign subsidiary is not taxed on the subsidiary's income until the income is remitted (or "repatriated") to the parent. The deferral of U.S. tax liability on the subsidiary's income continues indefinitely as long as the income is reinvested in the subsidiary or other foreign subsidiaries, rather than remitted to the U.S. parent. A tax credit in the amount of foreign taxes paid on repatriated income after gross-up (i.e. after adding back foreign income taxes paid to the actual dividend) is allowed at the time of repatriation.

An exception to the general deferral principle is provided under subpart F of the Code (sections 951–964). Under these sections, income from so-called tax haven activities conducted by corporations controlled by U.S. shareholders is deemed distributed to the shareholders and taxed to them as earned. Tax haven activities are generally sales and services artificially structured to channel income from high tax jurisdictions to lower tax jurisdictions.

By comparison to the treatment of foreign subsidiary income, income from all foreign branches of U.S. corporations is taxed the same as income earned in the United States since the branches are parts of U.S. corporations.

Impact

Companies that operate subsidiaries in countries with effective income tax rates lower than the U.S. rate may receive tax benefits from this provision.

A substantial portion of the revenue loss is attributable to deferral on shipping income, which is estimated to account for about $200 million of the current revenue loss. This occurs because shipping firms are often based in countries without income taxes, such as Liberia and

Panama. U.S. Department of Commerce data indicate that 445 of the 706 foreign flag ships owned by U.S. corporations and their subsidiaries are registered in Panama or Liberia. Much (508) of this total shipping fleet is composed of tankers.

Rationale

Historically, the United States has not taxed foreign source income of foreign corporations on the premise that only domestic corporations or income with a U.S. source is subject to U.S. jurisdiction. The separate corporate status of foreign subsidiaries of domestic corporations generally has been respected. In 1962, these principles were abrogated for tax haven income under subpart F of the Code. Subpart F was subsequently strengthened by the Tax Reduction Act of 1975 and the Tax Reform Act of 1976. Such income is taxed even though earned abroad and even though not repatriated.

Further Comment

Opponents of deferral allege it encourages investment in foreign countries and reduces domestic investment. They argue this reduces U.S. tax revenues and U.S. exports, and adversely affects the balance of payments, the balance of trade, and domestic employment. Proponents deny such allegations, and argue that deferral must be continued for U.S. corporations to remain competitive with foreign companies in overseas markets.

Deferral of tax on foreign profits is not neutral compared to investment in the United States in the sense that if the foreign country tax rate is less than the U.S. tax rate and the income is not going to be repatriated, a U.S. corporation has a tax incentive to invest abroad using a foreign subsidiary instead of investing at home. However, the deferral rules do neutralize advantages foreign competitors may have over U.S. corporations operating abroad. Moreover, there are also offsetting tax rules which favor investment in the United States by domestic companies rather than abroad, such as the general limitation of the investment credit and asset depreciation range (ADR) depreciation to assets used in the United States.

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SPECIAL RATE FOR WESTERN HEMISPHERE TRADE CORPORATIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	5	5
1979	------	15	15
1978	------	25	25

Authorization

Sections 921 and 922.

Description

Western Hemisphere Trade Corporations (WHTC's) are granted a special deduction which has the effect of reducing the tax rate on their income by as much as 5 percentage points in 1978. This provision is currently being phased out—to 2 percent in 1979 and elimination in 1980 and after.[1] The amount of the special deduction is the taxable income of the corporation (before the special deduction) multiplied by a fraction, the numerator of which is the appropriate percentage (e.g. 5 percent in 1978) and the denominator of which is the overall tax rate (the sum of the normal tax rate and the surtax rate, or 48 percent) on the corporation's total taxable income.

A WHTC is a U.S. corporation: (1) all of whose business is done in the Western Hemisphere; (2) 95 percent or more of whose income over the last 3 years was derived from sources outside the U.S.; and (3) 90 percent or more of whose income over the same 3 years was derived from the active conduct of a trade or business.

WHTC's may not defer U.S. taxation of their income (as in the case of a controlled foreign corporation), but they may take a tax credit for foreign taxes imposed on that income. The WHTC deduction may not be taken for a taxable year in which the corporation is a Domestic International Sales Corporation (DISC), or in which it owns any stock in a DISC or former DISC.

Example

If taxable income is $100,000 when computed without regard to the WHTC deduction, the WHTC deduction equals $100,000×(5 percent/48 percent)=$10,416.67; taxable income is reduced to $89,583.33 and the tax liability on this amount is $29,500 (assuming a 20-percent rate on the first $25,000 of taxable income, a 22-percent rate on the

[1] Under the present temporary corporate rate structure, the full 5 percentage point reduction applies to all WHTC's with income in excess of $55,814. Corporations with less income obtain a deduction which will reduce their tax rate by less than 5 percentage points. The full 2 percentage point reduction for 1979 will apply to firms with income of $26,087 under the permanent tax rate structure.

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next $25,000 and a 48-percent rate on the income in excess of $50,000). Without this special deduction, the tax would have been $34,500. Thus, the effective tax rate has been reduced by 5 percentage points.

Impact

For many companies, tax deferral through foreign incorporation has been more advantageous than the WHTC provision. But, since only domestic corporations may take percentage depletion, companies with Western Hemisphere extractive industry operations outside the United States were traditionally organized as WHTC's. Currently, however, the WHTC provision yields little or no tax saving for such operations because the application of large foreign tax credits completely or nearly completely offsets any U.S. tax liability.

The WHTC provision also has been used by sales subsidiaries. However, the more recent DISC legislation can be more valuable in many cases, and the absence of growth in use of WHTC's may reflect replacement of WHTC sales subsidiaries by DISC's.

Rationale

The Revenue Act of 1942 enacted the WHTC provision to exempt a few corporations then engaged in operations outside the United States but within the Western Hemisphere from the high wartime corporate surtaxes. The provision was continued in 1950 when the tax structure was changed, and provided a 14-percent rate reduction. It continued to be justified by some persons as necessary to maintain the competitive position of corporations competing in the Western Hemisphere with foreign corporations. The phaseout of the provision was enacted in the Tax Reform Act of 1976. The reasons for the elimination of the provision were multiple: a general tax equity rationale, a recognition of the displacement of the provision by the DISC legislation, a declining value due to higher foreign tax rates, and tax simplification.

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EXPENSING OF RESEARCH AND DEVELOPMENT COSTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	35	1,610	1,645
1979	30	1,520	1,550
1978	30	1,450	1,480

Authorization

Section 174.

Description

Taxpayers may elect to deduct costs for research and development as incurred (i.e., these costs may be "expensed") even though such costs may be associated with income that is earned over several years. The cost then is deducted before the income it generates is realized.

Impact

The mismatching of costs and income operates, as accelerated depreciation does, to defer tax liability, and thereby provides the taxpayer with an interest-free loan.

For example, if Corporation Z spends $1,000 on an R&D program in a given taxable year, the entire sum is treated as a deduction from taxable income, and represents a cash flow of $480 to the firm ($1,000 ×48 percent marginal tax rate=$480). The *value* of the current expense treatment, however, is the amount by which the present value of the immediate deduction exceeds the present value of periodic deductions taken over the useful life of the expenditure.

The direct beneficiaries of this provision are firms that undertake research and development. Mainly, these are large manufacturing corporations. The scanty evidence available suggests that, of the total amount claimed as research and experimental costs, about 10 percent is basic research and 90 percent is product development.

Expensing of research and development costs for tax purposes is consistent with the recent practice of a growing number of companies that expense these costs for financial accounting purposes. This treatment was approved by the Financial Accounting Standards Board in October 1974.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class[1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	0
10 to 20	3.3
20 to 30	3.3
30 to 50	13.3
50 and over	80.0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

This provision was added to the tax law in 1954. The general rule, then as now, was that the cost of assets that benefit future years must be capitalized and amortized over the assets' useful lives. Probably because there was difficulty in determining the useful life of such benefits, deduction was generally allowed for research and development costs. The treatment in a specific case was determined by the IRS administrative practice and court decisions. The purposes of the 1954 statute were to eliminate uncertainty in this area and to encourage expenditures for research and development.

Selected Bibliography

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EXPENSING OF INTANGIBLE DRILLING, EXPLORATION AND DEVELOPMENT COSTS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	360	1,080	1,440
1979	300	965	1,265
1978	300	885	1,185

Authorization

Sections 263(c), 465, 616–617, 704(d), and 1254.

Description

Except to the extent that the "at risk" rules described below apply, taxpayers engaged in drilling for oil and gas, in general, may deduct intangible drilling costs as incurred. Taxpayers engaged in other mining activities may deduct exploration and development costs as incurred (i.e., these costs may be "expensed").

Intangible drilling costs are certain expenses incurred in bringing a well into production, such as labor, materials, supplies, and repairs. Expenses for tangibles such as tanks and pipes are recovered through depreciation.

Intangible drilling costs may not be deducted in excess of the amount an individual or partnership has "at risk," or has actually invested, in an oil or gas drilling venture. This rule is applied on a property-by-property basis for individuals, and on all oil and gas properties in the case of partnerships and small business corporations treated as partnerships.

Amounts deducted as intangible drilling costs in excess of those amounts which would have been deducted if the costs were capitalized are recaptured as ordinary income upon the sale or other disposition of the property.

Mining exploration costs are those for the purpose of ascertaining the existence, location, extent, or quality of a deposit incurred before the development stage, such as core drillings and testing of samples. These expenses are limited in the case of foreign exploration. Foreign exploration costs cannot be expensed after the taxpayer has total foreign and domestic exploration costs of $400,000. Development expenses include those incurred during the development stage of the the mine, such as constructing shafts and tunnels, and in some cases drilling and testing to obtain additional information for planning operations. There are no limits on the current deductibility of such

costs. Although both intangible drilling costs and mine development costs may be taken in addition to percentage depletion, mining exploration costs subsequently reduce percentage depletion deductions. In the case of mines, as in the case of oil and gas intangible drilling costs, there are "recapture" provisions under which capital gains from the sale of the property are treated as ordinary income to the extent of prior deductions for exploration expenses.

Impact

Generally, expenditures that improve assets yielding income over several years must be capitalized and deducted over the period in which the assets produce income. The tax advantage of treating these expenditures as current expenses is the same as any other use of premature deductions; the taxpayer is allowed to defer current tax liabilities; this treatment amounts to an interest-free loan (see Appendix A).

These expensing provisions are additional benefits which supplement the special percentage depletion allowances extended to the mineral industry.[1] Although the expensing and depletion provisions operate somewhat independently, a firm or person may be eligible for both and receive their combined benefits.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2.4
10 to 20	3.8
20 to 30	3.8
30 to 50	15.2
50 and over	74.8

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The option to expense intangible drilling costs (as well as dry hole costs) of oil and gas wells developed through regulations issued in 1917 (19 Treas. Dec., Int. Rev. 31 (1917)). These regulations reflected the view that such costs were ordinary operating expenses. In 1942, the Treasury Department recommended that the provisions be removed, but Congress did not consider the suggestion. (Hearings on Revenue Revision of 1942 before the Committee on Ways and Means, p. 2996, vol. 3, 77th Cong., 2d sess.) In 1945, when a court decision invalidated the regulations (*F.H.E. Oil Co.* v. *Commissioner*, 147 F.2d 1002, 5th Cir. 1945), Congress adopted a resolution (H. Con. Res. 50, 79th Cong., 1st sess.) approving the treatment and later incorporated it into law in the 1954 code. The legislative history of this resolution indicates that it was intended to reduce uncertainty in mineral exploration and stimulate drilling for military and civilian purposes. (H. Rept. No. 761, 79th Cong., 1st sess., pp. 1–2.) Expensing of

[1] Percentage depletion has been eliminated for larger producers of oil and gas, and is being reduced for other producers; see pages 33–35, below.

mine development expenditures was enacted in 1951 to reduce ambiguity in the then existing treatment and to encourage mining. The provision for mine exploration was added in 1966.

Prior to the Tax Reform Act of 1969, a taxpayer could elect either to deduct without dollar limitation exploration expenditures in the United States, which subsequently reduced percentage depletion benefits, or to deduct up to $100,000 a year with a total not to exceed $400,000 of foreign and domestic exploration expenditures without the application of the recapture rule. The 1969 Act subjected all post-1969 exploration expenditures to recapture.

The restriction of deductions to amounts "at risk" for intangible drilling costs and the inclusion of intangible drilling costs in recapture rules were added by the Tax Reform Act of 1976, primarily in response to concerns about tax shelters in oil and gas drilling.

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EXCESS OF PERCENTAGE OVER COST DEPLETION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	405	1,310	1,715
1979	370	1,210	1,580
1978	340	1,120	1,460

Authorization

Section 613 and 613A.

Description

Most firms engaged in oil, gas, and other mineral extraction are permitted to deduct a "depletion" allowance for the exhaustion of the mineral deposits. There are two methods of calculating depletion: percentage depletion and cost depletion. Taxpayers who qualify for percentage depletion must use it if it is greater than cost depletion.

Under percentage depletion, a taxpayer deducts a fixed percentage of gross income from mining as a depletion allowance, regardless of the amount invested in the deposit. The deduction for gas and oil (which was 27.5 percent from 1926–69) is now set at 22 percent. However, beginning in 1975 the percentage depletion allowance was repealed for major oil and gas companies. Other companies (independents) were exempted from repeal for 2,000 barrels a day for 1975. The amount of this exempt portion is being phased down gradually to 1,000 barrels a day by 1980. In addition, beginning in 1981, the depletion rate will be gradually phased down by 1984 to 15 percent for qualifying producers.

Percentage depletion also applies to other mineral resources at percentages currently ranging from 22 percent to 5 percent. Sulphur, uranium, and most other metals mined in the United States qualify for the 22 percent rate; however, domestic gold, silver, and iron ore qualify for a 15-percent rate; most minerals mined outside the U.S. qualify for a 14-percent rate; coal qualifies for a 10-percent rate; and several forms of clay, gravel, and stone qualify for 5- and 7½-percent rates.

Percentage depletion may not exceed 50 percent of the net income from the property. This limitation is known as the "net income limitation." The total cost which can be recovered by percentage depletion is *not* limited to the cost of the property.

Cost depletion resembles depreciation based upon the number of units produced. The share of the original cost deduction each year is

equal to the portion of the estimated total production (over the lifetime of the well or mine) which is produced in that year. Using cost depletion, capital recovery cannot exceed the initial cost.

The value of the percentage depletion provision to the taxpayer is the amount of tax savings on the excess of the percentage depletion over cost depletion.

Impact

Issues of principal concern are the extent to which percentage depletion: (1) decreases the price of qualifying oil, gas, and other minerals, and therefore encourages their consumption; (2) bids up the price of drilling and mining rights; and (3) encourages the development of new deposits and increases production.

Most analyses of percentage depletion have focused on the oil and gas industry, which prior to 1975 accounted for the bulk of percentage depletion. Since 1975 legislation repealed the percentage depletion allowance for most oil and gas production, only one-quarter of oil and gas production is estimated to be currently eligible for percentage depletion. Sales of all other mineral deposits were unaffected by the 1975 legislation.

Because of the prior focus on oil and gas percentage depletion, there has been relatively little analysis of the impact of percentage depletion on other industries. The relative value of the percentage depletion allowance in reducing the effective tax rate of mineral producers is dependent on a number of factors, including the statutory percentage depletion rate and the effect of the net income limitation.

In the past, the net income limitation kept the effective percentage depletion rate for coal at around 6 percent although the statutory rate is 10 percent. Because the rising price of imported oil has increased the average price of all oil, coal has been substituted for oil, resulting in dramatic increases in the price of coal. The price increases will make the net income limitation inapplicable to much coal production, so the effective depletion rate is likely to rise to nearly the statutory rate.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2. 3
10 to 20	3. 6
20 to 30	3. 6
30 to 50	15. 1
50 and over	75. 4

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Deductions in excess of depletion based on cost were first allowed in 1918 in the form of "discovery value depletion" which allowed depletion on the market value of the deposit after discovery rather than on its cost. The purpose was to stimulate exploration during wartime and to relieve the tax burdens on small-scale prospectors.

However, the Treasury believed that under this system taxpayers often established high discovery values, and thus claimed excessive depletion. In 1926, to avoid the administrative problems raised by the need to establish market value, Congress substituted percentage depletion for oil and gas properties. Beginning in 1932, percentage depletion was extended to most other minerals.

In 1950, President Truman recommended the reduction of percentage depletion to a maximum of 15 percent, but Congress failed to take action on this recommendation. Only minor changes were made until 1969, when the depletion allowance for oil and gas was reduced from 27.5 percent to 22 percent, and "excess" depletion was made subject to the minimum tax beginning in 1970.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Mineral Industries," in Arnold C. Harberger and Martin J. Bailey, eds., *The Taxation of Income From Capital*, The Brookings Institution, Washington, D.C., 1969, pp. 77–122.

U.S. Congress. Senate. Committee on Interior and Insular Affairs. *An Analysis of the Federal Tax Treatment of Oil and Gas and Some Policy Alternatives*, Committee Print, 93d Cong., 2d sess., 1974.

CAPITAL GAINS TREATMENT OF ROYALTIES ON COAL AND IRON ORE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations		
	Coal	Iron	Total	Coal	Iron	Total
1980	70	10	80	20	10	30
1979	60	10	70	15	10	25
1978	50	5	55	15	5	20

Authorization

Section 631(c).

Description

Lessors of coal and iron ore deposits (which have been held more than 1 year prior to disposition or lease) in which they retain an economic interest may treat royalties as capital gains rather than as ordinary income. Percentage depletion is not available in such cases.

This provision cannot be used by taxpayers obtaining iron ore royalties from related individuals or corporations. No similar limitation applies to coal royalties.

Impact

The extent to which this provision results in tax saving depends on how the benefits compare with those from percentage depletion. In past years, percentage depletion on coal often has been large enough relative to profits to subject many firms to the "net income limitation" which limits percentage depletion to 50 percent of net income. This apparently has not been the case for iron ore where the percentage depletion deduction is less likely to be subject to the net income limitation.

For corporations, a percentage depletion deduction equal to 50 percent of net income reduces the marginal tax rate to 24 percent (one-half of 48 percent), whereas capital gains treatment results in a 30-percent tax rate. However, if the mine has a high basis for calculating cost depletion (which can be claimed ratably as an offset to capital gains), the election of this provision may result in a lower tax. Similarly, if the percentage depletion deduction is less than the net income limitation, capital gains treatment may be preferred.

For individuals, the tax reduction from the capital gains deduction is equivalent to that for percentage depletion when the net income limitation is applicable—taxable income is reduced by 50 percent. If the net income limitation for percentage depletion does not apply, or if the individual elects the alternative capital gains rate, capital gains treatment will be more favorable.

In view of recently rising coal prices, the percentage depletion allowance will be less likely to reach the net income limitation, and thus less likely to reduce tax rates by one-half. The value of newly purchased coal deposits also will be likely to rise—thus increasing the value of cost depletion. As a consequence, capital gains treatment which reduces tax rates by one-half for individuals may become relatively more valuable than percentage depletion for a larger number of individuals.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	Percentage distributions	
	Coal	Iron
0 to 10	2. 2	0
10 to 20	6. 6	0
20 to 30	8. 9	0
30 to 50	15. 6	20
50 and over	66. 7	80

[1] The distributions refer to the individual tax expenditures only. The corporate tax expenditures resulting from these tax provisions are not reflected in these distribution tables.

Rationale

Capital gains treatment for coal royalities was adopted in the Revenue Act of 1951. The legislative history suggests it was adopted to: (1) extend the same treatment to coal lessors as that allowed to timber lessors (see p. 49); (2) provide benefits to long-term lessors with low royalty rates who were unlikely to benefit significantly from the percentage depletion deduction; and (3) encourage the leasing and production of coal.

Capital gains treatment of iron ore royalties was added in the Revenue Act of 1964 to make the treatment of iron ore generally consistent with coal, and to encourage leasing and production of iron ore deposits in response to foreign competition.

Selected Bibliography

Agria, Susan. "Special Tax Treatment of Mineral Industries," in Arnold C. Harberger and Martin J. Bailey, eds., *The Taxation of Income from Capital*, The Brookings Institution, Washington, D.C., 1969, pp. 77–122.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform*, Hearings, testimony of E. V. Leisenring, National Coal Assn., 93d Cong., 1st sess., Mar. 19–20, 1973, pp. 2223–30.

EXCLUSION OF INTEREST ON STATE AND LOCAL GOVERNMENT POLLUTION CONTROL BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	145	300	445
1979	130	265	395
1978	110	220	330

Authorization

Section 103(b)(4)(F).

Description

Interest on industrial development bonds used to finance the construction or purchase of air and water pollution control facilities is excludable from gross income. (For a description of industrial development bonds generally, see pp. 61–63.)

As in the case of other industrial development bonds, a State or local government issues pollution control bonds which the government promises to pay only from rents received from facilities built with the bond proceeds. The proceeds are used to construct or purchase pollution control equipment which is leased to a private firm. This firm then guarantees payment of the bonds. The promise to pay rent by the private firm is sufficient to secure the bonds. The interest on the bonds is tax exempt because in form, but not in substance, the bonds are debt of a State or local government qualifying for exemption.

Impact

Tax-exempt pollution control bonds subsidize the cost of complying with antipollution regulations. Because the interest is tax exempt, the issuer can attract bond purchasers with lower interest rates than the lessee of the pollution control equipment would pay if it issued taxable bonds. In this manner, the exclusion from gross income of the interest reduces the interest cost of private pollution control equipment.

Financing for electric utility pollution abatement facilities dominates the pollution control bond market. In 1976 and 1977, issues sold for this purpose constituted 50.2 percent and 65.3 percent of the total dollar value of all pollution control issues, respectively. In 1976, other principal users of these bonds were metal producers and processors (13.5 percent), oil companies (12.7 percent), chemical companies (10.1 percent), and paper companies (5.9 percent). Most pollution control bond issues are made to finance pollution control equipment for large firms.

Reported pollution control bond sales rose from an estimated $93 million in 1971 to $2.98 billion in 1977. This constituted 6.6 percent of total long-term municipal debt and 88.2 percent of all industrial development bonds issued in 1977. However, unreported pollution control bond sales may be very substantial.

Outstanding pollution control debt in 1976 was estimated at $9.1 billion, and sales are projected to grow at an accelerating rate in the next few years. High growth rates reflect increasingly comprehensive and stringent antipollution requirements, and a greater willingness to utilize these bonds after experience has proven them a viable financial mechanism.

Projected rapid growth rates have led some bond market experts to predict strong pressure on all tax-exempt interest rates, a reduction in the attractiveness of tax-exempt issues generally relative to taxable issues, and a consequent dilution of the effectiveness of the exclusion.

Critics claim further that, as with the exclusion of interest on all State and local debt, some of this foregone revenue flows into investors' pockets without reducing actual borrowing costs. For example, it is estimated that every $.75 of interest saved by State and municipal governments because the interest on their bonds is not taxable, costs the Treasury $1.00 of revenue foregone. In fiscal year 1977, an estimated $4.8 billion in Federal revenue was foregone to save State and local governments about $3.6 billion in interest costs. The estimated difference of $1.2 billion was tax relief to investors. The reasons for this difference are discussed in the section on exclusion of interest on general purpose State and local debt, pp. 181–184.

Although many different types of investors buy pollution control bonds, fire and casualty insurance companies are the single largest group of pollution control bondholders. These companies are attracted to the high yields and long maturities of industrial revenue bonds relative to general obligation issues. Their need for liquidity is low relative to that of commercial banks, the other major institutional buyer of municipal obligations. According to one survey, 18 large fire and casualty insurance companies with 57 percent of industry assets purchased 55 percent of the volume of pollution control bonds sold in 1973. These purchases accounted for 30 percent of all tax-exempt obligations acquired by these companies in 1973.

Since 1973, participation in the pollution control bond market by these companies has declined. Part of the slack has been taken up by the household sector through municipal bond investment funds.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	0
10 to 20	1.2
20 to 30	3.5
30 to 50	8.2
50 and over	87.1

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

Congress lifted the constraints on tax-exempt pollution control bonds in the Tax Reform Act of 1969 in anticipation of the passage of antipollution regulatory legislation. Since the projected costs of compliance were considered high, Congress created a vehicle through which the Federal Government would share these costs with the private sector.

Further Comment

As with other tax-exempt municipal debt, the proliferation of pollution control bonds has elicited suggestions for alternative subsidies to pollution control facilities. These include subsidized taxable bond options and greater reliance on other tax incentives, such as special investment tax credits and immediate deduction of the cost of pollution control equipment.

Selected Bibliography

Criz, Maurice, and David Kellerman. "Unlisted Pollution Control Debt Via IDB's Held Exaggerated," *The Weekly Bond Buyer*, Jan. 28, 1976, pp. 1, 8.

Forbes, Ronald W., and John E. Petersen. "Background Paper," in *Building a Broader Market: Report of the Twentieth Century Fund Task Force on the Municipal Bond Market*, McGraw-Hill, New York, 1976, pp. 43–54, 77–88.

Fortune, Peter. "The Financial Impact of the Federal Water Pollution Control Act: The Case for Municipal Bond Reform," Harvard Institute of Economic Research, Cambridge, Mass., 1975.

Lane, Leonard Lee. "Do Pollution Control Bonds Control Pollution?" *Tax Notes*, Mar. 29, 1976, pp. 22–23.

Petersen, John. "The Pollution Control Bond: A Costly Subsidy," *Tax Notes*, Mar. 29, 1976, pp. 16–21.

Peterson, George, and Harvey Galper. "Tax-Exempt Financing of Private Industry's Pollution Control Investment," *Public Policy*, Winter 1975, pp. 81–103.

30-560—78——4

CONTRIBUTIONS TO CAPITAL OF REGULATED PUBLIC UTILITIES IN AID OF CONSTRUCTION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	10	10
1979	------	10	10
1978	------	10	10

Authorization

Sections 118(b) and 362(c).

Description

"Contributions in aid of construction" to water and sewage disposal utilities are not included in the utilities' gross income if the contributions are spent for the construction of certain facilities within 2 years after receipt of the contributions. This treatment is extended only to regulated utilities that provide water or sewage disposal services to the general public in their service areas. In general, a qualifying contribution in aid of construction is made by a builder or developer, either as funds paid to a qualifying utility which uses them to build water or sewage disposal facilities, or else as completed facilities transferred to the utility. Customer connection fees do not qualify as nontaxable capital contributions. These connection fees include payments made by customers for the cost of installing connections between their property and a utility's main water or sewage line.

Qualifying contributions may not be included in the rate base for ratemaking purposes by the regulatory body having ratemaking jurisdiction. No depreciation may be claimed and no investment credit may be taken with respect to any property acquired as the result of a qualified expenditure.

Impact

If contributions in aid of construction were taxable currently, utilities would: (1) pay tax on the contributions; (2) claim the investment credit on facilities constructed with the qualifying contributions; and (3) depreciate the facilities over their appropriate useful lives. Thus, if contributions were currently taxable, over time, utilities would recover the resulting tax payments through depreciation deductions. In effect, compared to the treatment of contributions in

aid of construction as taxable income, the treatment as non-taxable contributions under sections 118(b) and 362(c) constitutes a tax deferral rather than an exclusion.

Since amounts collected as contributions to capital are not included in a utility's rate base, they cannot result in increased rates to consumers or increased utility gross income. Absent the exclusion, the costs of water or sewage disposal contributions in aid of construction probably would be passed on by a utility to the developers and builders who receive services directly related to these contributions. In turn, the developers and builders would pass on part or all of the costs to their customers. Alternatively, to some degree, the increased utility costs might be borne in the form of higher utility rates by ratepayers generally, even though many of them do not use the specific facilities related to the contributions.

Rationale

Prior to 1958, all public utilities had been permitted to exclude from gross income currently the contributions they had received in aid of construction of facilities. In 1958, under Rev. Rul. 58–555, the IRS limited this favorable treatment to regulated utilities.

However, in 1975, in Rev. Rul. 75–557, the IRS held that amounts paid by a home purchaser as a connection fee to obtain water service were includable currently in a utility's income.

For many regulated utilities, the issuance of Rev. Rul. 75–557 had no tax effect as far as connection fees were concerned because these fees had historically been included in gross income. The problem, however, was that Rev. Rul. 75–557 might have been construed by the IRS as applying to more than just connection fees, and might have subjected to tax for the first time contributions in aid of construction, which previously had been excluded as non-shareholder contributions to capital. It was unclear under the relevant case law whether various types of contributions in aid of construction constituted taxable income. The present statute was enacted in 1976 to clarify the exclusion for regulated water and sewage utilities, subject to the limitations described above.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 635–38.

FIVE-YEAR AMORTIZATION OF POLLUTION CONTROL FACILITIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	40	40
1979	------	−45	−45
1978	------	−130	−130

Authorization

Sections 46(c) and 169.

Description

In lieu of depreciation, pollution control facilities that have been certified by both State and Federal agencies may be amortized ratably over a 5-year period (i.e., 20 percent of the cost may be deducted each year). Only the portion of the cost relating to the first 15 years of useful life is eligible. This rapid amortization is currently available only with respect to facilities added to plants in existence before 1976. Certification requires that the new facility be a new identifiable treatment facility that: (1) is used in connection with a plant or other property to abate or control pollution; and (2) does not significantly increase the output or capacity, reduce the operating costs, extend the useful life of the plant, or alter the nature of the manufacturing process or facility. The facility must comply with the Federal Water Pollution Control Act and the Clean Air Act.

Taxpayers may take an investment credit on one-half of the cost of property that is amortized under this provision, has a useful life of at least 5 years, and otherwise would qualify for the credit.

Impact

Prior to the Tax Reform Act of 1976, the amortization provision was used much less widely than it otherwise would have been because no investment credit was allowed. The allowance of half the investment credit under the 1976 law makes the provision more attractive, but its value is still reduced by the inability to use the full credit. To the extent that it is used, 5-year amortization for assets with longer useful lives benefits the taxpayer by effectively deferring tax liability. (See Appendix A.)

Rather than functioning as an incentive, the 5-year amortization of pollution control facilities subsidizes corporations that must comply with Federal or State pollution laws. State pollution regulations vary,

and there are regional cost differences for a given facility; both may account for geographical differences in the usage of the subsidy.

Rationale

Section 169 was introduced for a 5-year period to ease the financial burden of complying with environmental regulations when the Tax Reform Act of 1969 repealed the investment tax credit. When the investment tax credit was reinstated in 1971, rapid amortization was retained as an option.

The availability of the provision was extended in 1974, but was allowed to lapse. It was reinstated by the Tax Reform Act of 1976. This Act also allowed an investment credit on one-half of the cost of property for which rapid amortization is chosen. The purpose of this liberalization was to relieve more of the burden imposed on producers because of pollution control requirements. The 1976 Act also substantially broadened the definition of pollution control equipment eligible for the amortization.

Further Comment

The House voted in August 1978 to allow a full investment credit on the cost of pollution control facilities for which rapid amortization is elected, provided the property amortized under the provision has an actual useful life of at least 5 years.

Selected Bibliography

McDaniel, Paul R., and Alan S. Kaplinsky. "The Use of the Federal Income Tax To Combat Air and Water Pollution," *Boston College Industrial and Commercial Law Review*, February 1971, pp. 351–86.

Moore, Michael L., and G. Fred Streuling. "Pollution Control Devices: Rapid Amortization Versus the Investment Tax Credit," *Taxes*, January 1974, pp. 25–30.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 619–21.

TAX INCENTIVES FOR PRESERVATION OF HISTORICAL STRUCTURES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	5	5	10
1979	5	5	10
1978	(1)	------	(1)

[1] Less than $2,500,000.

Authorization

Sections 167(n), 167(o), 191, and 280B.

Description

Tax incentives and disincentives are provided to encourage the preservation of historic structures. A taxpayer is permitted to elect 5-year amortization of capital expenditures (in lieu of claiming allowable depreciation deductions) incurred in rehabilitation of a certified historic structure. Amortization in excess of otherwise allowable depreciation must be recaptured as ordinary income upon sale of the property. These rules apply to improvements made before June 15, 1981. Alternatively, a taxpayer may elect to be treated for depreciation purposes as if he were the original user of a substantially rehabilitated property and obtain the benefit of accelerated depreciation. This election applies to improvements made before July 1, 1981.

No deduction is allowed for amounts expended for, or losses sustained as a result of, the demolition of a certified historic structure. This rule applies to demolitions beginning before 1981. No accelerated depreciation is permitted for real property constructed on a site where a certified historic structure had been demolished. This rule applies to construction costs incurred before June 15, 1981.

Impact

Prior to enactment of these provisions in 1976, the tax laws lacked incentives for preservation of historic structures. Current deductions were allowed for demolition costs and for the remaining undepreciated basis of a demolished structure. Accelerated depreciation was permitted for new structures, but generally not for used ones. The new incentive provisions permit the taxpayer to defer tax liability.

Since issuance of temporary regulations implementing these provisions in March 1977, the Department of the Interior has received requests through mid-1978 for approval of some 470 rehabilitation plans.[1]

Rationale

These tax provisions were adopted in 1976 to further the goal of rehabilitating and preserving historic structures and neighborhoods. Achievement of this goal was thought to be dependent upon the enlistment of private funds in the preservation movement. Congress believed tax considerations play an important role in determining whether private interests will maintain and rehabilitate historic structures.

Selected Bibliography

Lifton, Marcy A. "Historic Preservation and the Tax Reform Act of 1976," *University of San Francisco Law Review*, Spring 1977, pp. 453–516.

"Symposium: Perspectives on Historical Preservation," *Connecticut Law Review*, Winter 1975–76.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 643–45.

[1] No estimated distribution of the individual tax expenditure by expanded gross income class is provided because in 1977, the year covered by the distributions prepared by the Treasury Department, there was very little usage of this provision by individuals, and no distribution was prepared.

TIMBER: CAPITAL GAINS TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	70	250	320
1979	65	230	295
1978	60	205	265

Authorization

Sections 631 (a) and (b), 1221 and 1231.

Description

If a taxpayer has held standing timber or the right to cut it for more than 1 year, the taxpayer may elect to treat the cutting of this timber as the sale of a long-term capital asset at a price equal to its fair market value on the first day of the taxable year. If an election is made, gain or loss accruing before the first day of the year in which the cutting occurs is treated as long-term capital gain or loss. Changes in the value of the timber after the first of the year result in ordinary income or loss, and not capital gain or loss. Capital gains treatment also can apply to the sale of a stand of timber and the sale of timber as it is cut by the buyer. Timber includes ornamental evergreens that are 6 years of age or more when severed from the roots.

Some of a timber owner's costs which maintain or even arguably improve his trees, such as disease control and thinning costs, can be expensed currently (see Appendix A), even though their effects may continue beyond the year in which they are made, and though they are related to income which only will be recognized many years in the future. Therefore, timber ownership offers opportunities for some taxpayers to deduct current expenses associated with such ownership against ordinary income from other sources.

Impact

The capital gains treatment of the cutting and sale of timber constitutes a departure from the general rule that sale of a taxpayer's inventory yields ordinary income. However, when timber is inventory, it is usually held substantially longer than other types of inventory.

Both individual and corporate taxpayers are eligible for this treatment. The graduated structure of the individual income tax rates

makes the provision more beneficial to individuals with high incomes because the value of the deduction for capital gains increases with the marginal income tax rate.

Two industries—paper and allied products and lumber and wood products—claim disproportionately large amounts of corporate capital gains. According to 1975 Preliminary Statistics of Income for Corporations, 29 percent of taxable income of paper and allied products industries and 46 percent of taxable income of lumber and wood products were long-term capital gains. This proportion may be contrasted with a proportion of 3.6 percent for all other corporations. These two industries reported 29.5 percent of all corporate capital gains while accounting for only 4.0 percent of taxable income. Treasury Department studies published in 1969 indicated that in these industries five corporations accounted for about one-half of the capital gains claimed, 16 firms accounted for about two-thirds, and 80 percent of the gains were accounted for by approximately 60 corporations.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	1.8
10 to 20	5.4
20 to 30	9.0
30 to 50	16.4
50 and over	67.3

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The sale of a timber stand that had not been held in the course of business was long considered the sale of a capital asset. The Revenue Act of 1943 extended this capital gain treatment to all persons who cut and sell their timber and to those who lease timber stands for cutting. One reason for adopting this provision was to equalize treatment between the taxpayer who sold timber as a stand outright, and the taxpayer who cut timber for use in his business. It was also suggested that this treatment would encourage conservation of timber through selective cutting and that taxing the capital gain at ordinary rates was an unfair practice because of the comparatively long development time of timber.

Selected Bibliography

Briggs, Charles W., and William K. Condrell. *Tax Treatment of Timber*, 5th ed., Forest Industries Committee on Timber Valuation and Taxation, Washington, D.C., 1969.

Sunley, Emil M., Jr. "The Federal Tax Subsidy of the Timber Industry," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, pp. 317–42.

U.S. Congress. House Committee on Ways and Means and Senate Committee on Finance. *Tax Reform Studies and Proposals: U.S. Treasury Department*, Committee Print, 91st Cong., 1st sess., Feb. 3, 1969, pp. 434–38.

AGRICULTURE: EXPENSING OF CERTAIN OUTLAYS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	480	80	560
1979	460	75	535
1978	445	70	515

Authorization

Sections 162, 175, 180, 182, 278, 447, 464, 465, and 704(d), Regulations 1.61–4, 1.162–12, and 1.471–6.

Description

Certain farm businesses, generally individuals and family-owned corporations, may use the cash method of tax accounting to deduct costs attributable to goods held for sale and in inventory at the end of the tax year. These businesses also are allowed to expense (i.e. deduct as they are incurred) some costs of developing assets that will produce income in future years. Both of these rules deviate from generally applicable tax accounting rules, which do not permit deduction of inventory costs until the inventory is sold, and which require the cost of income-producing assets to be deducted over their useful lives. These rules thus allow deductions to be claimed before the income associated with the deductions is realized.

Items that may be deducted before income from them is realized include cattle feed, expenses of planting crops for the succeeding year's harvest, and development costs such as those incurred in planting vineyards and fruit orchards. There are special rules that require outlays for developing young citrus and almond groves to be capitalized.

In addition, certain costs that otherwise would be considered capital expenditures may be deducted immediately by all farmers pursuant to specific sections of the Internal Revenue Code. These costs include expenses for soil and water conservation (section 175), land clearing (section 182), and fertilizer (section 180).

Certain restrictions primarily aimed at tax shelters apply to farming deductions. Farm syndicates are restricted in their deductions of pre-production expenses, and farm loss deductions allowable to individual taxpayers are restricted to amounts "at risk," or actually invested, in a farming venture.

Impact

The effect of deducting costs before the associated income is realized is the understatement of income in the year of deduction followed by

an overstatement when the income is realized. The net result is that tax liability is deferred from the time the deduction is taken to the asset's productive period. This affords the taxpayer an interest-free loan in the amount of the deferred tax. When the income is finally taxed, it may be taxed at preferential capital gains rates (see p. 53 below).

The expensing of capital outlays provides a general incentive for farming investments that qualify for this treatment, and particularly favors farming investments with long development periods (such as orchards and vineyards).

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	5. 3
10 to 20	18. 1
20 to 30	17. 1
30 to 50	24. 8
50 and over	34. 7

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The special rules with respect to development costs and cash accounting were established in regulations issued very early in the development of the tax law. At that time, because accounting methods were less sophisticated, tax rates were low, and the typical farming operation was small, the regulations apparently were adopted to simplify recordkeeping for the farmer. The statutory rules permitting deductions for soil and water conservation, land clearing expenses, and fertilizer costs were added between 1954 and 1962 to encourage conservation practices. The special requirements for capitalizing outlays for citrus and almond growers were enacted in 1969.

The Tax Reform Act of 1976 required accrual accounting for some farm corporations, and restricted deductions associated with tax shelters, in recognition, respectively, of the more sophisticated accounting methods available to some corporate farmers, and the growth of tax shelters.

The remaining use of cash basis accounting for individual and some corporate farmers is still justified by its proponents as simpler, more workable, and more consistent than the accrual method.

Selected Bibliography

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform*, Panel Discussions, Part 5—Farm Operations, 93d Cong., 1st sess., Feb. 8, 1973, pp. 615–96.

———. *Tax Reform*, Hearings, Part 2—Farm Operations, 94th Cong., 1st sess., July 15, 1975, pp. 1360–1402.

———. *Tax Shelters: Farm Operations*, Committee Print, 94th Cong., 1st sess., Sept. 6, 1975.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 40–62.

AGRICULTURE: CAPITAL GAINS TREATMENT OF CERTAIN INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	385	10	395
1979	365	10	375
1978	350	10	360

Authorization

Sections 1201–1202, 1221–1223, 1231, 1245, and 1251–1252.

Description

If gains from the sale or exchange of property used in a trade or business exceed losses from such property in any year, the gain is treated as a long-term capital gain. Real estate or depreciable property used in farming operations and held for more than a year, but not held for sale, generally qualifies as such property. However, horses and cattle qualify only if they have been held more than 24 months.

In some cases, all or much of the cost of the farm property used in the business has previously been deducted under the farm accounting rules discussed on pages 51–52. Consequently, in 1969, Congress enacted legislation to tax as ordinary income some gains previously taxed as capital gain. These gains include those from the sale of land held for less than 10 years, but only to the extent of previously deducted soil and water conservation expenses. They also included gains from other farm property to the extent of the amount in the taxpayer's excess deduction account. The excess deduction account was the cumulative total of farm losses which exceeded $25,000 in any year when nonfarm income exceeded $50,000. The excess deductions account was reduced by net farm earnings and gains that were treated as ordinary income. Under the 1976 Tax Reform Act, which restricted farm loss deductions, additions to this excess deductions account for 1976 and later years were terminated. Recapture provisions will still apply, however, to the extent of previously accumulated amounts in excess deductions accounts.

Impact

Subject to these rules, taxpayers owning farm assets may obtain long-term capital gains treatment on qualifying assets even though much of the asset cost has been deducted against ordinary income. While this favorable tax treatment is limited to property used in the farming

business, many farm assets have a dual potential of being held for sale or for use in the business. Assets having this ambiguous nature are often sold before the ambiguity is resolved, and the gain is treated as capital gain. Over 90 percent of the tax saving is claimed by noncorporate farmers. The tax benefit per dollar of capital gain increases with the taxpayer's marginal tax rate.

In the past, the interaction between the deduction of costs and capital gains treatment for the sale of such assets resulted in many tax shelter operations in farming. However, restrictions on farm loss deductions enacted in 1976 (discussed on pages 51–52), have limited the attractiveness of farm tax shelters in general.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class[1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	1.5
10 to 20	7.0
20 to 30	8.2
30 to 50	15.4
50 and over	67.9

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Preferential treatment for capital gains for individuals was introduced in 1921. However, long-term capital gain treatment for property used in a trade or business was not enacted until 1942. Between 1942 and 1951, there was a dispute whether livestock qualified as such property, and legislation in 1951 gave livestock that status. The 1942 legislation was enacted to provide tax relief for war-related gains. Restrictions on loss deductions were enacted in 1976 to limit the use of farming tax shelters.

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COOPERATIVES: DEDUCTIBILITY OF NON-CASH PATRONAGE DIVIDENDS AND CERTAIN OTHER ITEMS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	−190	560	370
1979	−185	525	340
1978	−175	490	315

Authorization

Sections 1381–1388.

Description

A cooperative is allowed to deduct earnings distributed to its customers (or patrons) in the form of "patronage dividends" or "per unit retain" allocations. Patronage dividends must be determined on the basis of the quantity or value of business done with the patron, and by reference to the cooperative's earnings from business with patrons. Per unit retain allocations are based upon the quantity of products marketed without reference to the cooperative's earnings.

The deduction applies to both cash dividends and non-cash dividends in the form of certificates allocating amounts—retained by the cooperative—to the patrons. In order for a cooperative to deduct the non-cash patronage dividends: (1) at least 20 percent of the allocation must be in cash; and (2) the allocation must be included in the patron's income, unless it is related to personal, non-business expenses. Per unit retains also may be deducted by the limited types of cooperatives that can issue them, although the retains only represent allocations of earnings to patrons and are not cash dividends. A patron must treat all his patronage dividends and per unit retain allocations as taxable income.

Impact

The deduction of patronage dividends, and particularly non-cash dividends, allows a cooperative effective exemption from the corporate income tax, while the cooperative still retains its earnings for reinvestment through the use of certificates of allocation. For example, if all dividends were paid in allocations, a cooperative could retain 80 percent of its earnings and incur no Federal income tax liability.

The most significant cooperatives qualifying for this treatment are agricultural cooperatives, although substantial numbers of nonagri-

cultural cooperatives, such as consumer cooperatives, also benefit from these provisions. Cooperative credit institutions are not eligible for this special treatment, although they do benefit from other tax expenditures. Qualifying cooperatives either may be purchasing or marketing cooperatives, and may be involved in manufacturing processes as well. Exemption from the Federal income tax provides a competitive advantage for cooperatives, many of which are substantial in size, over competing incorporated businesses.

Rationale

The treatment of patronage dividends derives initially from rulings issued early in the 1920's which allowed patronage dividends to be deducted by cooperatives. There was no explicit rationale for such treatment, but apparently the rulings resulted from the requirement that cooperatives make these dividend payments. It was argued these payments either were costs of goods sold or price reductions, and therefore should be deductible.

In 1951, when certain formerly exempt cooperatives were made taxable, a requirement was added that patronage dividends of exempt and non-exempt cooperatives be treated in the same manner. The legislative history indicates that the intent of Congress was to tax all earnings of cooperatives either to the patron, stockholder, or cooperative. However, when the Treasury attempted to tax allocated patronage dividends to the patrons, a series of court decisions ending with *Long Poultry Farms, Inc.* v. *Commissioner* 249 F. 2d 726 (4th Cir. 1957), held that allocation certificates were of contingent value and were not to be included in income. Thus, such allocations were taxable neither to the cooperative nor the patron. As a consequence, sections 1381–1388 were added in 1962 to insure that such allocations were taxable either to the patron or the cooperative.

Further Comment

Two theories are advanced for allowing the deduction of patronage dividends. The first is that such dividends actually constitute price reductions to the patrons. The second is that all earnings of the cooperative belong to its patrons, and that the cooperative is an agency of its members rather than a separate taxable enterprise.

On the other hand, current tax law treats cooperatives as taxable entities, and the deduction of patronage dividends results in effective tax exemption. Allocated patronage dividends arguably do not constitute price reductions, but rather are non-negotiable, non-interest-bearing notes redeemable by the patrons, if ever, in the indefinite future. One might question why patrons accept such allocations in lieu of cash if the intent is a price reduction. The answer may be that the interest of the patrons is that of investors. This response is particularly relevant since cooperatives are typically owned, either through stock ownership or otherwise, by patrons.

Persons arguing that patronage dividends are not comparable to price reductions note that price reductions in a normal business have a profit motive—expanding sales and increasing profit. So-called "price reductions" for cooperatives in the form of patronage dividends, however, have the purpose of eliminating profit.

It is argued by some that even if the patronage dividends and per unit retains are viewed as dividends, the tax rules governing cooperatives do not result in a tax expenditure because the patrons are taxed on the dividends and retains they receive or have attributed to them. In effect, the patrons are taxed as if they receive cash dividends and re-invest them in the cooperatives. However, the estimated revenue foregone by allowing the cooperatives full deductions for these dividends and retains far exceeds the estimated additional tax revenues paid by patrons on their patronage dividends and per unit retains.

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DIVIDEND EXCLUSION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	530	------	530
1979	505	------	505
1978	475	------	475

Authorization

Section 116.

Description

An individual may exclude up to $100 ($200 on a joint return) of dividends received from domestic corporations.

Impact

Although this provision benefits all taxpayers who receive dividend income and have tax liability, only a small percentage of total dividends is affected by the provision because of the dollar limitation. The tax saving per dollar of exclusion increases with the taxpayer's marginal tax bracket. In the aggregate, the benefits tend to accrue to middle- and high-income taxpayers because they are more likely to own stock.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	9. 1
10 to 20	24. 0
20 to 30	24. 7
30 to 50	23. 3
50 and over	18. 9

Rationale

In 1954 a dividend exclusion of $50 and a credit against tax liability for 4 percent of dividends above that amount were adopted. The stated purpose was to provide partial relief from the "double taxation" of dividends (the corporate income tax and the individual income tax on dividends) which, it was argued, hampered the ability of companies to raise capital. The exclusion was stated to be designed to afford greater relief for the low-income investor.

In 1964, although the Administration recommended repeal of both the credit and exclusion, the credit was repealed and the exclusion was doubled. The reasons offered were (1) that the provisions had not achieved their objectives, (2) the change would remove the discrimination in favor of high-income taxpayers, (3) the change would encourage broader ownership of stock, and (4) the change would raise revenues that could be used to reduce the individual taxes in general.

Further Comment

As indicated above, the issue that gave rise to the initial enactment of the exclusion and credit is the "double taxation" of dividends or, more generally, the burden of taxes on capital, and on corporate equity capital in particular. While the exclusion survives, it does relatively little to resolve this problem because of the low dollar ceiling. Many proposals for partial and full integration of the corporate and individual income taxes have been made. Partial integration proposals were seriously considered, but not proposed, by the Carter Administration in 1977. They have also been the subject of Congressional hearings, and have been discussed in recent years in the House Ways and Means Committee.

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EXCLUSION OF INTEREST ON STATE AND LOCAL INDUSTRIAL DEVELOPMENT BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	155	315	470
1979	135	270	405
1978	115	235	350

Authorization

Section 103(b).

Description

The interest on industrial development bonds (IDB's) issued by State and local governments to finance eight categories of investments are excludable from gross income regardless of issue size. The eight categories are: (A) residential family housing; (B) sports facilities; (C) convention or trade show facilities; (D) airports, docks, wharves, mass commuting facilities, and parking facilities; (E) sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy or gas; (F) air or water pollution control facilities;[1] (G) facilities for furnishing water made available to the public; and (H) the acquisition or development of land for an industrial park.

The interest on IDB issues that finance other types of industrial plant and equipment investments is generally not excludable from gross income unless the issue has a face value of $1 million or less. Under certain conditions, a State or local government can elect to raise this limit to $5 million.

Unlike general obligation issues, industrial development bonds are not backed by the issuing government. Rather, the bonds are guaranteed by a business. The issuer uses the proceeds of the bonds to finance the investment in plant and equipment which the business intends to utilize. The issuer typically leases the equipment back to the private firm, including in the rent the interest costs of financing the bond issue. Only the rent is available to secure the bonds.

Impact

Tax-exempt IDB's subsidize private investments. Since interest on IDB's is tax exempt, potential purchasers are willing to accept lower before-tax rates of interest than on taxable securities. Consequently,

[1] For discussion of the exclusion of interest on pollution control IDB's see pp. 39 41.

the issuing government can attract bondholders with lower interest payments than corporations selling comparable bonds in the taxable market. By financing investment through IDB's, a private firm can therefore lower its borrowing costs.

Benefits of the tax exemption are conferred on both the holders of IDB's and the private firms using them as financing mechanisms. The allocation of benefits between the holders and the businesses depends on the spread in interest rates between the tax-exempt IDB market and the taxable bond market. The smaller the spread, the larger the proportion of benefits accruing to the IDB bondholders.

Firms which guarantee IDB's most extensively tend to be large. Of all exempt IDB issues (other than for pollution control) listed in the January 1977 issue of *Moody's Bond Record*, 62 percent were issued on behalf of 104 different members of the "Fortune 500." However large firms tend to dominate IDB usage less now than they did before 1969. Of all exempt IDB's (other than pollution control) issued prior to 1969, 71 percent were on behalf of members of the "Fortune 500." Since 1969, less than 60 percent of such issues have been on behalf of these firms. This shift probably resulted from the fact that prior to 1969, interest on all industrial revenue bonds, regardless of the magnitude or purpose of the issue, was excludable from gross income.

In 1976, $357 million in tax-exempt non-pollution-control IDB's were issued nationally. This constituted 11.8 percent of all tax-exempt IDB's issued.

As an exclusion, the value of this tax expenditure increases with the marginal tax rate of the bondholder. Consequently, within the household sector, IDB's tend to be held by high-income investors. Fire and casualty insurance companies are attracted to IDB's because of their relatively high yields and long maturities. Commercial banks, the other major group of institutional investors in the municipals market, have a greater need for liquidity than the insurance companies. In general, they prefer bonds which are relatively short-lived and serialized. General obligations tend to possess these characteristics more than do IDB's.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	0
10 to 20	2. 1
20 to 30	3. 2
30 to 50	8. 4
50 and over	86. 3

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

The tax-exempt status of industrial revenue bonds was originally established in the courts on the ground of State sovereignty. Mississippi issued the first industrial revenue bonds as part of legislation to "Balance Agriculture With Industry" (BAWI). The constitutionality of Mississippi's BAWI Act was upheld in 1938 by the Mississippi Supreme Court. An appeal was dismissed by the U.S. Supreme Court for lack of a substantial Federal question.

Many early IDB issues were intended to promote industrial development, particularly in agricultural labor surplus areas during the Great Depression. IDB's continued to be used predominately for this purpose through the 1940's and 1950's, mostly in the Southeast. The 1960's saw an increase in the number and size of issues, and the proliferation of IDB-financed facilities into urban areas and other regions. Between 1959 and 1968, the number of reported issues rose from 88 to 212. The dollar value of issues rose from $32.4 million to an estimated $1.8 billion. By 1968, IDB's were in use in 40 States.

Dollar limitations were placed on the size of tax-exempt IDB issues in 1969 for several reasons: the growing revenue loss to the Federal Treasury; the intensification of financially debilitating competition for industry among municipalities through the extension of IDB financing; the substantial use of IDB's by large corporations that already had ample financial resources; and the pressure on interest rates throughout the municipals market generated by IDB growth.

Further Comment

Several bills have been introduced recently in Congress to relax the dollar limitations on the size of tax-exempt issues. In order to redirect tax-exempt IDB's toward the purpose of promoting industrial development in depressed areas, some have recommended that the dollar limitations be eased only for facilities located in depressed regions.

The House voted in August 1978 to raise from $5 million to $10 million the limitation on the size of the small issue election for tax-exempt industrial development bonds.

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EXEMPTION OF CREDIT UNIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	100	100
1979	------	90	90
1978	------	80	80

Authorization

Section 501(c)(14).

Description

Credit unions without capital stock, and organized and operated for mutual purposes and without profit, are not subject to Federal income tax.

Impact

Because their income is exempt from the income tax, credit unions are treated more favorably than are competing financial institutions whose income is taxed. On the other hand, credit unions are subject to certain special constraints not required of their competitors, such as limits on the interest rate charged on loans, on the duration of loans, and on the types of investments that are allowed. In addition, credit unions may lend only to members; however, only a small deposit may be required for membership that qualifies the member for a loan greatly in excess of the deposit.

Rationale

Credit unions have never been subject to the Federal income tax. Initially, they were included in the provision that exempted domestic building and loan associations—whose business was at one time confined to lending to members—and nonprofit cooperative banks operated for mutual purposes. The exemption for mutual banks and savings and loan institutions was removed in 1951, but credit unions retained their exemption. No specific reason was given for continuing the exemption of credit unions.

Further Comment

The Carter Administration proposed in 1978 that credit unions no longer be exempt from the Federal income tax, but rather be treated in the same manner as thrift institutions. The Treasury Department indicated that the basis for this proposal was that many credit unions are no longer truly mutual institutions with limited "common bonds," and are becoming virtually indistinguishable from other financial institutions.

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BAD DEBT DEDUCTIONS OF FINANCIAL INSTITUTIONS IN EXCESS OF ACTUAL LOSSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	930	930
1979	------	790	790
1978	------	705	705

Authorization

Sections 585, 593, and 596; Revenue Rulings 65–92 (C.B. 1965–1, 112), 68–630 (C.B. 1968–2, 84).

Description

In general, businesses are permitted to deduct as a current operating expense a reasonable allowance for bad debts. The allowance usually is based on the experience of prior years. However, the special formulae used by financial institutions to compute bad debt reserves permit deductions in excess of actual experience.

Prior to 1969, commercial banks were permitted a bad debt deduction of 2.4 percent of outstanding loans. The 1969 Tax Reform Act reduced this figure to 1.8 percent for years through 1975, 1.2 percent from 1976–81, and 0.6 percent from 1982 through 1987. After 1987, commercial banks will be limited in their loss reserve deductions to actual recent loss experience.

As an alternative to this treatment available for commercial banks, mutual savings banks and savings and loan associations have an option, under certain circumstances, to deduct a specified percentage of their taxable income. Under the provisions of the Tax Reform Act of 1969, this percentage-of-net-income allowance is being reduced from 60 to 40 percent by 1979. (The allowance for 1978 is 41 percent of taxable income.) Thereafter, the percentage allowance will remain at 40 percent. The total bad debt reserve of thrift institutions may not exceed 6 percent of qualifying real property loans, or the percentage-of-net-income bad debt deduction will be disallowed. In addition, the annual bad debt deduction under this latter method will be reduced if the thrift institution's investments do not comprise specified proportions of certain "qualified" assets, which for "thrifts" are essentially residential mortgages.

Impact

Bad debt reserve deductions in excess of actual experience lower the effective tax rates of financial institutions, particularly thrift institutions, below the normal corporate tax rate of 48 percent. Apart from any other means of reducing tax liability, the 60 percent bad debt allowance resulted in a maximum effective tax rate for a thrift institution prior to the 1969 Tax Reform Act of 19.2 percent.[1] With full phase-in of the bad debt provisions of the 1969 Act, the maximum effective tax rate of a thrift institution qualifying for the full bad debt allowance will be 28.8 percent.[2] Therefore, to the extent the bad debt deduction induced thrift institutions to hold qualified assets, such as residential mortgages, before 1969, the provisions of the 1969 Act have reduced the incentive effect of this tax expenditure.

Rationale

The tax treatment of commerical banks evolved separately from that of thrift institutions. The allowance for special bad debt reserves of commerical banks was first provided by IRS ruling in 1947, when there was fear of a postwar economic downturn. It was intended to reflect the banking industry's experience during the depression period.

The special treatment of bad debt reserves for thrift institutions was added by statute in 1951. Prior to that time, savings and loan associations and mutual savings banks were exempt from taxation, in most instances because they were viewed as mutual organizations rather than corporations. Upon removal of this tax-exempt status, special, and very favorable, treatment of bad debt reserves was provided for savings and loan institutions and mutual savings banks, which in effect left them virtually tax exempt for a number of years thereafter. Some of the same factors which led to their tax exemption probably account for the special allowance for bad debts, especially the belief that these institutions fill an important role in providing home mortgage funds.

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[1] .48−.6(.48)=.192.
[2] .48−.4(.48)=.288 (without taking the minimum tax into account).

DEDUCTIBILITY OF MORTGAGE INTEREST AND PROPERTY TAXES ON OWNER-OCCUPIED HOMES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations	Total
	Property taxes	Mortgage interest		
1980	5, 750	6, 140	------	11, 890
1979	5, 180	5, 530	------	10, 710
1978	4, 665	4, 985	------	9, 650

Authorization

Sections 163 and 164.

Description

A taxpayer may take an itemized deduction for mortgage interest and property taxes paid on his owner-occupied home.

Impact

The deduction of nonbusiness mortgage interest and property taxes allows homeowners to reduce their housing costs; tenants have no such opportunity because they cannot deduct rental payments.[1] High income individuals receive greater proportional benefits than low income persons, not only because of higher marginal tax rates, but also because higher income taxpayers are more likely to own one or more homes and to itemize deductions. Higher income people also are likely to own higher priced homes with larger mortgages and higher property taxes.

These provisions encourage home ownership by reducing its cost in comparison to renting. Some observers believe that these deductions, together with other favorable income tax provisions accorded to homeowners, have been an important factor in the rapid rise of homeownership since World War II. Other observers suggest that the housing market has adjusted for these deductions, and that home price increases have compensated for the tax benefit.

To the extent that the deductibility of State and local property taxes allows these taxes to be higher than they would otherwise be, the provision has an effect similar to a revenue sharing program.

[1] In contrast to the rental income paid to a landlord by a tenant, the rental value of an owner-occupied home is not imputed—i.e., not included—in the income of the owner. Such income thus is tax exempt, but the mortgage interest and property tax expense of earning it is allowed as a deduction from other taxable income. These deductions favor investments in owner occupied homes over investments in residential rental property or other assets such as securities.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	Percentage distributions	
	Property taxes	*Mortgage interest*
0 to 10	1. 9	2. 0
10 to 20	19. 4	24. 5
20 to 30	28. 4	36. 0
30 to 50	24. 6	25. 2
50 and over	25. 7	12. 3

Rationale

Generally, the deductibility of interest and of State and local taxes has been a characteristic of the Federal income tax structure since the Civil War income tax. An explicit rationale was never advanced, but close examination of the legislative histories suggests that these payments were viewed as reductions of income. No distinction was made between business and nonbusiness expenses. There is no evidence that deductibility of these items was originally intended to encourage home ownership or to stimulate the housing industry, which are the present justifications offered for this treatment.

The code was revised in 1964 to specify the types of nonbusiness taxes which could be deducted. The treatment for property taxes was retained because removing the deduction would have precipitated a large shift in overall tax burdens.

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DEDUCTIBILITY OF INTEREST ON CONSUMER CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	2,610	------	2,610
1979	2,350	------	2,350
1978	2,120	------	2,120

Authorization

Section 163.

Description

A taxpayer may take an itemized deduction for interest paid or accrued on nonbusiness indebtedness (for example, personal and auto loans and credit account purchases).

Impact

This provision reduces net interest charges, and thereby reduces the price of consumer purchases financed by debt. Because higher income taxpayers are more likely to itemize deductions, they are more likely to benefit from this provision than are taxpayers in lower brackets.

Under 1954 legislation, the deduction for carrying charges on most consumer credit (unless explicitly denominated "interest") was limited to about 6 percent on the declining balance of consumer debt. In more recent years, bank charge cards have proliferated, and the Internal Revenue Service has ruled that charges on those cards generally can be fully deducted as interest. On the other hand, purchases under deferred payment contracts usually remain subject to the limitation previously mentioned. Thus, the theoretical treatment of bank charge cards differs substantially from deferred payment sales where carrying charges are often not called "interest." Whether this distinction is observed in practice is unknown.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2.0
10 to 20	24.5
20 to 30	35.9
30 to 50	25.2
50 and over	12.3

Rationale

While the 1862 income tax statute did not contain a special provision for the deduction of interest, it was allowed. When the income tax was reinstituted in 1913, a special provision allowing the deduction of interest was included, apparently because of concern that interest might not be treated as a business expense and deducted under the general business expense provision. At that time, no distinction was drawn between business and nonbusiness interest expense, presumably because the latter constituted a very small proportion of total interest expense. However, today the nonbusiness interest cost is perceived as a consumption item and hence different from business interest.

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EXPENSING OF CONSTRUCTION PERIOD INTEREST AND TAXES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	145	555	700
1979	90	525	615
1978	140	500	640

Authorization

Sections 163–164, 189.

Description

Interest and taxes incurred by a corporate taxpayer during the construction of a building either may be deducted or may be capitalized as a part of the depreciable base of the building. An individual taxpayer has the option of treating these costs either as a part of the depreciable base of the building, or as a separate capital cost to be amortized over specified time periods.

For nonresidential structures, the amortization period is 6 years for expenses paid or incurred in 1978. This 6-year period increases 1 year in each subsequent year, until it reaches 10 years in 1982. For residential buildings other than low-income housing, the pattern is the same except that the period begins at 4 years for expenses paid or incurred in 1978, and reaches 10 years in 1984. For low-income housing construction period interest and taxes, amounts paid or incurred before 1982 may be deducted fully in the year they are paid or incurred, subject to limitations on prepayments; amounts paid or incurred in 1983 may be amortized over 4 years; and the amortization period increases 1 year for each year thereafter until 1987, when it reaches 10 years.

Impact

The cost of interest and taxes paid or incurred during the construction period of a building is conceptually a cost of the constructed property. The allowance of such construction period costs as deductions when paid or incurred or over a period of time shorter than the useful life of the property results in a mismatching of income and expenses by allowing the deduction of costs prior to the realization of income related to the costs. In contrast, all other construction costs are required to be capitalized and depreciated over the useful life of the building. The effect of the construction period interest and taxes deduction is a deferral of income taxes in the nature of an interest free loan (see Appendix A).

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Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2. 0
10 to 20	3. 3
20 to 30	4. 0
30 to 50	14. 7
50 and over	76. 0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The deduction for interest and taxes was provided in the original income tax law in 1913. Although no specific rationale was stated, the legislative history suggests that such payments were viewed as reducing net income. In 1942, a provision was added to the law to allow taxpayers to elect to capitalize such costs. The Tax Reform Act of 1976 required the phased-in 10-year amortization period for individuals, which reflected a concern with the role this provision played in individual tax shelters. When interest and taxes were currently deducted, high income taxpayers could generate substantial immediate tax losses which could be used to shelter income earned from other sources.

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EXCESS FIRST-YEAR DEPRECIATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	165	50	215
1979	155	50	205
1978	145	45	190

Authorization

Section 179.

Description

All taxpayers except trusts may elect to take a first-year depreciation deduction equal to 20 percent of the first $10,000 of investment in tangible personal property ($20,000 in the case of a joint return) having a useful life of 6 or more years. This first-year depreciation reduces the basis of the asset. However, the remaining basis may be depreciated under rates that are otherwise applicable. Real property is not eligible for this treatment.

Example

Assume a taxpayer purchases a $10,000 asset with a 10-year tax life depreciated under the double declining balance method, and with no salvage value. Without the first-year depreciation, his deduction in the first year would be $2,000 (200 percent $\times$ $\frac{1}{10}$ $\times$ $10,000). In the second year, his deduction would be $1,600 (200 percent $\times$ $\frac{1}{10}$ $\times$ $8,000).

With the first-year depreciation allowance, his first-year deduction would be $2,000 (20 percent of $10,000) *plus* $1,600 (200 percent $\times$ $\frac{1}{10}$ $\times$ $8,000) or $3,600. In the second year his deduction would be $1,280 (200 percent $\times$ $\frac{1}{10}$ $\times$ $6,400).

Impact

This provision results in a deferral of tax liability and is similar to an interest free loan (see Appendix A). Because it is a deduction, the value is dependent on the taxpayer's marginal tax rate. It is available to all taxpayers except trusts, but is of most significance to small businesses because of the dollar limitations. As an incentive for the acquisition of new assets by small businesses, it has broader application than the corporate surtax exemption, since noncorporate businesses can take advantage of it.

The provision is often cited as assistance to new and growing small businesses which are likely to have limited access to capital markets, and are thus more dependent on internal funds for financing investment. However, many such businesses, particularly new ones, may not have sufficient taxable income to benefit from the provision.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2.1
10 to 20	3.6
20 to 30	3.6
30 to 50	15.0
50 and over	75.7

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

The provision was originally reported in the Small Business Tax Revision Act of 1958, which with some modifications was added in conference to the Technical Amendments Act of 1958. The additional first-year depreciation was intended to provide relief for small businesses that are dependent on internal financing, and to encourage investment in small business.

Further Comment

A number of proposals have been made to increase the dollar limits of this provision to reflect the impact of inflation. Proposals have also been made to shorten the minimum life of qualifying assets in view of the subsequent general reduction in asset useful lives. For example, the tentative decisions on tax reform adopted by the Ways and Means Committee in 1974, though never reported as a bill, would have increased the dollar limit to $15,000 ($30,000 for a joint return), and would have reduced the minimum useful life to 4 years.

In August 1978, the House passed a provision that would increase the first-year depreciation percentage to 25 percent, increase the dollar limitation on eligible property to $20,000 ($40,000 for individuals filing joint returns), but would allow additional first-year depreciation only to taxpayers with depreciable assets whose adjusted basis is less than $1 million.

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DEPRECIATION ON RENTAL HOUSING IN EXCESS OF STRAIGHT-LINE, AND DEPRECIATION ON BUILDINGS (Other Than Rental Housing) IN EXCESS OF STRAIGHT-LINE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Depreciation on rental housing			Depreciation on other buildings		
	Individuals	Corporations	Total	Individuals	Corporations	Total
1980	290	70	360	105	115	220
1979	290	70	360	115	130	245
1978	300	70	370	125	140	265

Authorization

Section 167(b) and (j).

Description

Taxpayers are allowed to recover the cost of their durable income producing assets that wear out or become obsolete by deducting from gross income an allocable portion of the cost of the assets. Normally these depreciation deductions are spread over the useful life of the asset, and the total amount equals the asset's cost less salvage value. Taxpayers are generally offered the choice of using the straight-line method (in which an equal amount of depreciation is deducted each year of the asset's life) or accelerated methods of depreciation (in which greater amounts are deducted in the early years). A taxpayer can switch from the declining balance or the sum of the years-digits methods of accelerated depreciation to straight-line depreciation when it becomes advantageous to do so as the asset grows older.

The use of accelerated depreciation on structures is limited as follows:

Residential Rental Units

(1) New construction may be depreciated under any method allowed by the Internal Revenue Code.

(2) Used buildings having at least a 20-year life when acquired may be depreciated under the declining balance method using a rate not in excess of 125 percent of the straight-line rate.

Other Structures

(1) New construction may be depreciated by any accelerated method which does not yield depreciation greater than the declining balance method using a rate not exceeding 150 percent of the straight-line rate.

(2) Used buildings may be depreciated on the straight-line method or any other reasonable method that is neither a declining balance or sum of the years digits method.

If a building is sold at a gain, some of the accelerated depreciation will be recaptured as ordinary income. Without recapture rules, all of the gain would be taxed as capital gain. However, the recapture concept is not fully applied to low-income housing.

Example

Assume a used residential structure with a basis of $10,000, an expected remaining life of 25 years, and no salvage value. If the straight-line method were used, the deduction would be $400 each year. Under accelerated depreciation, the first-year depreciation allowance can be computed as follows:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$10{,}000 = \$500$$

In the second year, the depreciation allowance is computed in the same way except the original basis of $10,000 is now reduced by the amount previously depreciated. Hence, the new basis equals $9,500. The second year computation is:

$$\text{Depreciation allowance} = 125\% \times 1/25 \times \$9{,}500 = \$475$$

Thus, in each succeeding year, there is a decrease in the amount of depreciation claimed for tax purposes, and therefore an increase in tax liability compared to what it would be otherwise.

Impact

Because accelerated depreciation allows for larger deductions in the early years of the asset's life and smaller depreciation deductions in the later years, accelerated depreciation results in a deferral of tax liability. It is a tax expenditure to the extent it is faster than economic (i.e. actual) depreciation. It is widely believed to be consistent with actual experience to allow accelerated depreciation for some machinery and equipment which, in many cases, decline in value more rapidly in their early years than later years. However, similar treatment for buildings is generally believed inconsistent with their rates of eonomic decline in value which are generally much slower than those of machinery and equipment.

The direct benefits of accelerated depreciation for structures accrue to owners of business buildings and rental housing. The benefit is estimated as the tax saving resulting from the depreciation deductions in excess of straight-line depreciation. About 81 percent of the

tax saving from rental housing and 47 percent of the tax saving from nonresidential buildings are estimated to accrue to individual owners in FY 1978. The remaining portion of each class of benefit goes to corporate owners.

Efforts to repeal accelerated depreciation for real estate have been opposed on the ground that without this treatment, real estate investments would be so unattractive relative to other forms of investment that drastic cutbacks in building would result. On the other hand, it is argued that the tax benefits increase the production of new buildings only to the extent that demand for new buildings responds to small price changes, and that this response is relatively small. The impact of accelerated depreciation on rental housing is generally estimated to be greater than for nonresidential buildings since the demand for housing is more price elastic.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class [1]

	Percentage distributions	
Expanded gross income class (thousands of dollars):	*Rental housing*	*Other buildings*
0 to 10	2. 2	2. 1
10 to 20	3. 4	3. 6
20 to 30	3. 7	3. 6
30 to 50	15. 0	15. 0
50 and over	75. 6	75. 7

[1] The distributions refer to the individual tax expenditures only. The corporate tax expenditures resulting from these tax provisions are not reflected in these distribution tables.

Rationale

Prior to 1954, depreciation policy had developed through administrative practices and rulings. The straight-line method was favored by IRS and generally used. A ruling issued in 1946 authorized the use of the 150 percent declining balance method. Authorization for it and other accelerated depreciation methods first appeared in legislation in 1954 when the double declining balance and other methods were enacted. The discussion at that time focused primarily on whether the value of machinery and equipment declined faster in their earlier years. However, when the accelerated methods were adopted, real property was included as well, even though it did not decline more rapidly in value in its first years.

By the 1960's, most commentators agreed that accelerated depreciation resulted in excessive allowances for buildings. In 1964, a provision was enacted which "recaptured" accelerated depreciation as ordinary income in varying amounts when a building was sold, depending on the length of time the property was held. However, recapture was not required for straight-line depreciation upon the transfer of real estate. In 1969, the "recapture" provision was strengthened, more in the case of commercial real estate which became subject to full recapture, but also to some degree in the case of rental housing. The Tax Reform Act of 1976 provided for complete recapture of subsequent accelerated depreciation for all residential real estate except low-income housing, which continues to receive more liberal treatment.

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ASSET DEPRECIATION RANGE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	165	3, 120	3, 285
1979	135	2, 640	2, 775
1978	115	2, 245	2, 360

Authorization

Section 167(m); Regulation 1.167(a)–11; Rev. Proc. 72–10.

Description

The Internal Revenue Service has established useful lives for classes of depreciable assets. The asset depreciation range (ADR) system permits taxpayers to choose any useful life within a range of 20 percent more or less than the class life otherwise established by the IRS for a particular asset. If ADR is chosen, the taxpayer is not required to justify retirement and replacement policies, nor to show that the useful lives selected for the assets are consistent with their actual useful lives.

Example

Assume that a taxpayer has a $1,500 asset for which the class life established by the Internal Revenue Service is 10 years. Using double declining balance depreciation without ADR, the deduction in the first year would be 200 percent$\times$.10$\times$$1,500=$300. After deduction of this depreciation charge, the adjusted basis of the asset is $1,200 ($1,500−$300). In the second year, the deduction would be 200 percent$\times$.10$\times$$1,200=$240.

Under the asset depreciation range, a useful life of between 8 and 12 years may be selected. If the taxpayer chooses 8 years, the first-year deduction would be 200 percent$\times\frac{1}{8}\times$$1,500=$375. In the second year, the deduction would be 200 percent$\times\frac{1}{8}\times$$1,125=$281.25. Therefore, the use of ADR would result in additional deductions of $75 the first year ($375−$300) and $41.25 the second year ($281.25−$240.00).

Impact

The ADR system, as accelerated depreciation (see Appendix A) reduces taxes early in the life of depreciable assets and thus increases cash flow during that time. The subsidy value of ADR is the tax saving from the allowance of a tax depreciation life shorter than the guideline life of the asset. Capital intensive businesses such as manufacturing firms and utilities necessarily can benefit most from ADR.

Securities and Exchange Commission data indicate significant use of ADR by railroads, utilities, airline companies, and truck and equipment companies. Treasury Department data indicate that the use of ADR is more probable the larger the size of a corporation. In 1974, 64 percent of all depreciable corporate assets were held by corporations that elected ADR. Nearly 92 percent of corporate taxpayers with depreciable assets of $1 billion or more elected ADR, and a little more than half of corporations with depreciable assets of $100 million or more elected ADR. In contrast, only 0.36 percent of corporate taxpayers with $500,000 or less in depreciable assets elected ADR.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	3.0
10 to 20	9.0
20 to 30	8.0
30 to 50	20.0
50 and over	60.0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

The ADR system was enacted in 1971 principally to stimulate investment and economic growth by deferring taxes through the acceleration of depreciation deductions. In addition, it was asserted the system would simplify the administration of the existing depreciation rules.

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CAPITAL GAINS (Other Than Farming, Timber, Iron Ore, and Coal)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	8, 585	635	9, 220
1979	7, 990	575	8, 565
1978	7, 430	540	7, 970

Authorization

Sections 1201–1254.

Description

Gains on the sale of capital assets held for more than 1 year are subject to preferentially lower tax rates (see Appendix B). Also, gain on the sale of property used in a trade or business is treated as long-term capital gain if all gains for the year on such property exceed all losses for the year on such property. Qualifying property used in a trade or business generally is depreciable property or real estate that is held more than 1 year, but not inventory.

For individual taxpayers, only one-half of long-term capital gains is included in income; or alternatively, on the first $50,000 of capital gain, the taxpayer may elect to pay a tax of 25 percent.

For corporate taxpayers, long-term capital gains generally require a dual tax computation. They are first included in income, and a tax on the total income, including the capital gain, is computed using the regular rates. In the "alternative" computation, a tax on all income other than long-term capital gain is computed at regular rates. The long-term capital gain is taxed at a 30-percent rate, and the two resulting taxes are added together to yield the "alternative" tax. The lower of the tax computed the regular way or the "alternative" tax is the tax liability. Thus, a corporation must include the full amount of net long-term capital gains in taxable income, but may apply the special 30-percent alternative capital gain tax rate on the gain.

Gain on most depreciable tangible personal property used in a trade or business will be treated as ordinary income to the extent it arises from depreciation that has been allowed after 1961, i.e., the depreciation is "recaptured"; but only some depreciation on real estate is "recaptured."

The untaxed portion of capital gains is the principal tax expenditure subject to the minimum tax for tax preferences. This additional tax may offset a portion of the benefits of capital gains taxation for individuals and corporations with substantial annual capital gains.

Example

To illustrate the calculation of capital gains taxation for corporations, assume a corporation has, for the taxable year 1978, taxable income of $250,000, which includes net long-term capital gains of $60,000.

Tax Computed in Regular Manner:	
Taxable income	$250, 000
Tax:	
(20 percent × $25,000)	5, 000
(22 percent × $25,000)	5, 500
(48 percent × $200,000)	96, 000
Total	106, 500
Alternative Tax:	
Partial tax on $190,000 ($250,000 − $60,000):	
(20 percent × $25,000)	5, 000
(22 percent × $25,000)	5, 500
(48 percent × $140,000)	67, 200
30 percent of $60,000	18, 000
Alternative tax	95, 700

The alternative tax is $10,800 less than the regular tax, and in this example, the tax expenditure is the tax savings attributable to the alternative tax computation.

Impact

For individuals, the deduction from gross income of half of capital gains results in tax rates half the normal rates. The alternative (25 percent) tax benefits only those individuals whose marginal tax rate is above 50 percent. The tax treatment of capital gains increases the after-tax earnings on assets, and thereby may encourage individuals to invest in assets which may appreciate in value. Furthermore, the tax preference may reduce the inhibiting effects of taxation on the sale of assets.

The benefits of this provision are concentrated among high income individuals, with approximately two-thirds of the benefit received by those with expanded gross incomes of $50,000 or more. The tax saving per dollar of capital gain increases with the tax bracket of the taxpayer.

Corporations with taxable income over the surtax exemption that realize income from the sale of long-term capital assets are the direct corporate beneficiaries of the general capital gains rules.

According to 1975 tax return data, capital gains taxed at alternative rates averaged 5 percent of taxable income for all corporations. Aside from farming and timber, iron ore, and coal to which special capital gains rules apply, industries which had a high ratio of capital gains to ordinary income were general building contractors, real estate companies, hotels, and investment companies.

In cases in which the minimum tax applies to offset some of the benefits of capital gains taxation, it generally will increase the maximum rate on capital gains by slightly less than 5 percentage points for individuals and by slightly more than 1 percent for corporations.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	1.7
10 to 20	6.9
20 to 30	8.1
30 to 50	15.6
50 and over	67.7

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting rom these tax provisions is not reflected in this distribution table.

Rationale

Although the original 1913 income tax law taxed capital gains at ordinary rates, the 1921 law provided for an alternative flat rate tax for individuals of 12.5 percent. This treatment was to minimize the influence of the high progressive rates on market transactions. The Committee Report noted that these gains are earned over a period of years, but are nevertheless taxed as a lump sum. Over the years many revisions in this treatment have been made, including the temporary adoption of a sliding scale treatment (where lower rates applied the longer the asset was held). The current basic approach for taxing capital gains of individuals was adopted as part of the Revenue Act of 1942. The alternative maximum 25 percent rate was limited to $50,000 of gains annually by the Tax Reform Act of 1969. Both the minimum tax on preference income and the maximum tax offset, which raise the capital gains rate for a limited number of taxpayers with capital gains, were first enacted in 1969 and then strengthened in 1976.

Prior to 1942, corporate capital gains were taxed in the same manner as ordinary corporate income. The 1942 Act also introduced the alternative tax for corporations at a 25-percent rate, the alternative tax rate then in effect for individuals. This tax relief was premised on the belief that many wartime sales were involuntary conversions which could not be replaced during wartime, and that resulting gains should not be taxed at the greatly escalated wartime rates. The Tax Reform Act of 1969 increased the alternative rate to 30 percent. This increase was based on several considerations, including the adoption of the limitation of the alternative capital gains tax for individuals to the first $50,000 of capital gains, and the absence of a major "bunching" problem (i.e., income earned over several years is recognized in a single year) which occurs more commonly in the individual tax because of graduated rates.

Further Comment

Many reasons have been advanced for preferential treatment of capital gains income of individuals, with the major ones being: (1) capital gains are accrued over a long period of time, and should not be subject to tax under progressive rates as a lump sum; (2) capital gains reflect inflation to a substantial extent and are thus not real income; and (3) because an asset owner has discretion as to when to realize gains, the application of ordinary tax would act as a barrier to transactions in the capital market and lead to "lock-in" effects (asset owners refrain from selling because of the tax), with attendant distorting effects on savings, investment, and economic efficiency.

On the other hand, the following arguments have been advanced against the preferential treatment of capital gains: (1) even if capital gains were taxed as ordinary income, the advantage remains of the deferral of tax on unrealized gains; (2) inflation affects returns on assets in general, not just capital gains transactions; (3) the "lock-in" problem might be resolved in other ways, such as taxing gains transferred at death (thus removing the opportunity to avoid capital gains taxes entirely); and (4) the "bunching" problem can be met by a special averaging provision.

The effect of the difference in tax rates on ordinary income versus capital gains is different for corporations and individuals for a number of reasons. More of the capital gain for corporations results from sales in the normal course of business. Further, the ability to exempt gains from tax by death transfers is not available for corporations. Finally, there is less of a "bunching" problem for corporations since the corporate rate is generally not a graduated rate.

In August 1978, the House voted to eliminate capital gains as an item of tax preference subject to the minimum tax. The House also agreed to repeal the 25 percent alternative tax on the first $50,000 of a noncorporate taxpayer's net long-term capital gain. In addition, the House agreed to exclude from tax the portion of capital gains that reflects the effects of inflation on the value of common stock, real property, and tangible personal property.

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DEFERRAL OF CAPITAL GAINS ON HOME SALES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1, 030	------	1, 030
1979	980	------	980
1978	935	------	935

Authorization

Section 1034.

Description

Gain from selling a residence is not taxed if the taxpayer purchases another residence with a cost at least equal to the sale price of the old residence within 18 months before or after the sale of the old residence. This treatment also applies if the seller constructs a new home of equal or greater value, if construction begins within 18 months of the sale, and if the taxpayer occupies the new residence within 2 years of the sale.

If the new residence costs less than the sale price of the old, the difference in price is subject to tax.

The tax basis of the new residence is reduced by the amount of the untaxed gain on the sale of the old residence. Therefore, the gain on the sale of the first home will be recognized, if at all, at the time of the sale of the second home. However, the tax may again be deferred on the gain from the sale of both homes if another home is purchased by a taxpayer meeting the requirements of section 1034. The interaction of section 1034 and section 121 which benefits those over 65 (see p. 163) will result in ultimate exemption from tax of part or all of the previously unrecognized gain if the taxpayer sells his second or subsequent home with a carryover basis after he is 65.

Impact

As with any tax deferral, the taxpayer receives the equivalent of an interest-free loan. This provision benefits primarily middle and upper income taxpayers. Ninety-six percent of the benefit accrues to those in the $10,000–$50,000 expanded gross income class. This subsidy facilitates the ownership of increasingly expensive homes, of which much of the increase in value in many cases is attributable to inflation.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	4. 0
10 to 20	42. 8
20 to 30	33. 7
30 to 50	14. 6
50 and over	4. 8

Rationale

The provision was adopted in 1951 to relieve financial hardship when a personal residence is sold, particularly when the sale is necessitated by such circumstances as an increase in family size or change in the place of employment. The Finance Committee Report noted that sales in these circumstances are particularly numerous in periods of rapid change such as mobilization or reconversion (presumably referring to wartime conditions).

Further Comment

Many have questioned the taxation of any gain from the sale of a personal residence, particularly since the tax law does not allow the deduction of personal capital losses, and because the purchase of a personal residence is less of a profit motivated investment than many other types of investment. On the other hand, tax deferral of gain from home sales does favor investment in homes as compared to other types of investment and, along with other features of the tax law, contributes to the generally favorable tax treatment afforded homeowners.

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EXCLUSION AND DEFERRAL OF CAPITAL GAINS TRANSFERRED AT DEATH AND BY GIFT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	9, 910	------	9, 910
1979	8, 975	------	8, 975
1978	8, 120	------	8, 120

Authorization

Sections 1001, 1002, 1014, 1015, 1023, 1040, 1221, and 1222.

Description

A capital gains tax generally is imposed on the increased value of a capital asset when the asset is sold or exchanged. However, this tax is not imposed on the appreciation in value when ownership of the property is transferred as a result of the death of the owner or as a gift during the lifetime of the owner. Only in certain circumstances when the property subsequently is sold by the heir or donee is the appreciation taxed that occurred when the asset was owned by the transferor. The heir and donee are thereby able to defer or avoid entirely the payment of income taxes on this appreciation.

All previously untaxed appreciation of capital assets will be taxed as a capital gain subject to adjustments when a donee sells property received as a gift from a living donor. However, only appreciation which occurred after December 31, 1976, will be taxed as a capital gain subject to adjustments when an asset is sold by an heir who received the property as the result of death. The gain in the former case may be reduced for State and Federal gift taxes, while the gain in the later case may be reduced for State and Federal death taxes. Gain on the first $60,000 in value of property is exempt under the death transfer rules. In addition, the executor of the estate may elect to exempt from income taxation up to $10,000 of appreciation in the value of household and personal effects.

Assets transferred at death or by *inter vivos* gift are subject to the Federal estate and gift taxes, respectively, based upon their value at the time of transfer.

Impact

The exclusion of capital gains at death is most advantageous to individuals who need not dispose of their assets to achieve financial liquidity. Generally speaking, these tend to be wealthier individuals.

30-560—78——7

The deferral of tax on the appreciation involved combined with the exemption for the appreciation before death is a significant benefit for these investors and their heirs.

Failure to tax capital gains at death encourages "lock in" of assets, which in turn means less turnover of funds available for investment. In deciding whether to change his portfolio, an investor takes into account the higher pre-tax rate of return he might obtain from the new investment, the capital gains tax he might have to pay if he changes his portfolio, and the capital gains tax his heirs might have to pay in the future if he decides not to change his portfolio. Often an investor in this position decides that, since the capital gains tax his heirs might incur is so distant and possibly avoidable, he should transfer his portfolio unchanged to the next generation. The lack of a tax on capital gains transferred at death or by gift provides a further incentive to this option. To the extent this option is taken, taxpayers are said to be "locked in" to investments.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	1. 8
10 to 20	6. 8
20 to 30	8. 1
30 to 50	15. 6
50 and over	67. 7

Rationale

The rationale for this treatment is not indicated in the legislative history of any of the several interrelated applicable provisions. However, one current justification given for the treatment is that death and *inter vivos* gifts are considered as inappropriate events to result in the recognition of income.

The exclusion of appreciation occurring prior to December 31, 1976, on assets transferred by death is to ease the transition from "step up" basis to "carryover" basis, which was included as part of the Tax Reform Act of 1976. Prior to this Act, all capital gains accruing during the lifetime of a decedent escaped income taxation entirely in the case of assets transferred by death. The basis of the property was "stepped up" or "stepped down" in the hands of the heir to its fair market value at the decedent's death. The Tax Reform Act of 1976 required that, in general, the basis of inherited property be the same in the hands of the decedent, i.e., that the basis be "carried over" from decedent to heir.

Further Comment

Taxation of capital gains at death would cause liquidity problems for some taxpayers, such as owners of small farms and businesses. Therefore, most proposals for taxing capital gains at death would combine substantial averaging provisions, deferred tax payment schedules, and a substantial deductible floor in determining the amount of gain to be taxed.

The $60,000 minimum valuation provided under current law for appreciated property transferred by death is designed to cushion the impact on small estates of the taxation of inherited capital gains when realized by the heir. The administration has recently proposed that the minimum valuation be raised to $175,000.

There is substantial controversy surrounding the "carryover" basis provisions enacted in 1976. Legislation under active consideration in Congress would defer implementation of these provisions for several years.

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CORPORATE SURTAX EXEMPTION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	2, 905	2, 905
1979	------	3, 540	3, 540
1978	------	3, 885	3, 885

Authorization

Section 11.

Description

The permanent corporate income tax consists of a normal tax rate of 22 percent and a surtax of 26 percent for a total tax rate of 48 percent. The first $25,000 of profits are exempted from the surtax.

Temporary provisions reduce the normal tax rate to 20 percent on the first $25,000 of profits and 22 percent on the next $25,000 of profits, and raise the exemption from the surtax to $50,000. These temporary rates are in effect only through 1978.

Impact

The surtax exemption is available to all corporations. It reduces tax liability for a corporation with $50,000 of taxable income by $6,500 under the permanent exemption, and by $13,500 under the temporary exemption through 1978. The exemption tends to neutralize the tax differential between a business operating as a sole proprietorship or a partnership and a corporation by lowering the corporate tax rate on the first $25,000 ($50,000 through 1978) to rates comparable to the individual rates.

The exemption encourages the use of the corporate structure and allows some small corporate businesses that might otherwise operate as sole proprietorships or partnerships to provide fringe benefits. It also encourages the splitting of operations between sole proprietorships, partnerships, and corporations. Most businesses are not incorporated; only about 5 percent of all businesses are affected by this provision, and not all of those receive the full tax benefit because their taxable income is less than $25,000 ($50,000 through 1978).

Rationale

Since almost the earliest days of the corporate income tax, some level of profits has been exempted from the full corporate tax rate. The split between a normal tax and a surtax was not, however, fully

accomplished until the Revenue Act of 1941. The surtax exemption in its present permanent form was adopted as part of the 1950 Revenue Act. The purpose was to provide relief for small businesses. However, many large businesses fragmented their operations into numerous corporations to obtain numerous exemptions from the surtax. Some remedial steps were taken in 1963; in 1969, legislation was enacted limiting groups of corporations controlled by the same interest to a single surtax exemption. The expanded temporary exemption was first enacted in 1975, and was continued in 1976 and 1977.

Further Comment

The House voted in August 1978 to repeal the present normal corporate tax and surtax and, in their place, impose a 5-step tax rate structure on corporate income. Under these changes, which would become effective in 1979, the first $25,000 of taxable corporate income would be taxed at 17 percent, from $25,000 to $50,000 would be taxed at 20 percent, from $50,000 to $75,000 would be taxed at 30 percent, from $75,000 to $100,000 would be taxed at 40 percent, and all taxable income over $100,000 would be taxed at 46 percent.

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INVESTMENT TAX CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	3, 020	13, 650	16, 670
1979	2, 725	12, 320	15, 045
1978	2, 390	10, 735	13, 125

Authorization

Sections 38 and 46–50.

Description

The investment tax credit (ITC) is available to any taxpayer who invests in income-producing property that is eligible for the credit.

Eligible investment is largely limited to tangible personal property, such as machinery and equipment, that is used in the United States. Most buildings are not eligible.[1]

The amount of the credit is subtracted from tax liability calculated without the credit. The credit is currently 10 percent of the qualified investment, but will revert to 7 percent (4 percent for regulated utilities) after December 31, 1980. The amount of investment that qualifies for the credit is the full purchase price of property with a life of at least 7 years, two-thirds for property with a useful life of from 5 to 7 years, one-third for property with 3- to 5-year life, and zero for property with a life of less than 3 years. Only $100,000 of investment in used property ($50,000 after December 31, 1980) qualifies in any year. The maximum credit that can be claimed in any one year generally is $25,000 plus 50 percent of tax liability over $25,000. This rule is temporarily liberalized for regulated utilities, railroads, and airlines. Any unused amount of the credit may be carried back 3 years and carried over 7 years (for pre-1971 carryovers a 10-year period is allowed). Use of the credit does not reduce the cost of an asset for purposes of calculating depreciation.

Impact

The credit has two effects. First, it increases the recipient's cash flow. Second, it reduces the cost of capital and, therefore, can turn an unprofitable investment into a profitable one (or a profitable one into

[1] With certain exceptions, investments eligible for the credit include depreciable or amortizable property having a useful life of 3 years or more and include: (1) tangible personal property; (2) other tangible property (not including a building or its components) used as an integral part of (a) manufacturing, (b) extraction, (c) production, or (d) furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services; (3) elevators and escalators; and (4) research facilities and facilities for the bulk storage of fungible commodities.

a more profitable one). Assume that an investor requires a 15-percent rate of return to undertake an investment project. A machine which costs $1,000 and provides an annual return of $135 does not meet the 15 percent target. However, since a 10-percent ITC reduces the net cost of the machine to $900, the $135 annual return with the credit meets the 15 percent standard (15 percent of $900=$135).

While noncorporate businesses and individual investors benefit from the credit, over 80 percent of the credit accrues to corporations. Since the credit is directly related to investment in durable equipment, much of the direct benefit is concentrated in manufacturing and utilities.

According to 1973 tax data, 65 percent of the ITC is claimed by corporations with assets of $250 million or more. Two major industry categories account for 78 percent of the credit: manufacturing (49 percent), and transportation, communication, electric, gas, and sanitary services (29 percent).

For some firms, e.g., public utilities, the credit on an investment may exceed the company's tax liability. Instead of purchasing the property, the firm may find it profitable to lease the equipment from a bank that is able to obtain full benefit from the credit. Securities and Exchange Commission data indicate substantial use of the credit by banks through leasing arrangements. A refundable investment credit has been recommended by some persons for business firms that lose unused credits at the end of the carry-forward period.

Several studies have produced little evidence that suggests the past changes in the application of the credit have been effective as *short-run* business cycle stabilization tools. Other studies have produced conflicting evidence as to the *long-run* effectiveness of the credit in stimulating investment which increases the rate of capital accumulation and economic growth.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	7.7
10 to 20	24.1
20 to 30	18.7
30 to 50	19.9
50 and over	29.6

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Originally adopted as part of the Revenue Act of 1962, the credit was intended to stimulate investment and economic growth. The credit was also justified as a means of increasing the ability of American firms to compete abroad and of compensating for the effect of inflation on capital replacement. The credit was modified in 1964, suspended in September 1966, restored in March 1967, repealed in April 1969, reenacted in August 1971, temporarily liberalized in March 1975 until the end of 1976, and in 1976, extended at the liberalized rate through 1980.

Further Comment

The House voted in August 1978 to make permanent both the 10 percent investment tax credit rate and the $100,000 maximum amount of used property that can qualify for the credit annually. The House also voted to increase the maximum amount of the credit that can be claimed annually from $25,000 plus 50 percent of tax liability over $25,000 to $25,000 plus 90 percent of tax liability in excess of $25,000. This change would be phased in at an additional 10 percentage points per year beginning in 1979. The House also agreed to extend the investment credit to rehabilitation expenditures incurred in connection with existing buildings used in all types of business or productive activities except buildings used for residential purposes.

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DEDUCTIBILITY OF NONBUSINESS STATE GASOLINE TAXES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	935	------	935
1979	840	------	840
1978	760	------	760

Authorization

Section 164(a)(5).

Description

State and local, but not Federal sales taxes on gasoline, diesel fuel, and other major fuels are deductible, even if the taxes are not trade or business expenses or expenses for the production of income.

Impact

This deduction benefits only taxpayers who own motor vehicles and itemize deductions rather than take the standard deduction. These tend to be middle and higher income taxpayers. Gasoline prices are reduced for taxpayers who claim the deduction, and the amount of this tax benefit per dollar of deduction increases with the tax bracket of the taxpayer.

State and local gasoline taxes are "user taxes" in the sense that the revenues they generate are generally earmarked for road maintenance and other State and local services provided highway users. The deduction allowed for these taxes is contrary to the general nondeductible treatment of user taxes. Therefore, one effect of this deduction is to shift some of the burden of these user taxes to all Federal taxpayers, regardless of the extent to which they use these local road facilities.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	3.2
10 to 20	30.9
20 to 30	36.3
30 to 50	20.1
50 and over	9.3

Rationale

Before 1964, a deduction for both business and nonbusiness State and local taxes was allowed in computing taxable income. The Revenue Act of 1964 eliminated the deduction for many taxes. The bill first passed by the Ways and Means Committee also eliminated the deduction for gasoline taxes, but the Senate Finance Committee restored it, and the Senate version was enacted. The stated rationale for retention of the deduction was to prevent large shifts in the tax burden of individuals, to assist the States with fiscal coordination in a Federal system, and to allow the States free choice in their selection of a tax structure.

Further Comment

There has been substantial recent interest in Congress in limiting the deduction for nonbusiness State and local gasoline taxes. The Senate Finance Committee reported the Tax Reform Act of 1976 with a $50 floor under the gasoline tax deduction so that only expenses in excess of $50 would be deductible. However, this provision was deleted on the Senate floor. The House voted to repeal the deduction as part of the Energy Tax Act of 1977.

The Carter Administration's 1978 tax proposals included repeal of the deduction. And again in August 1978, the House voted to repeal the deduction as part of the Revenue Act of 1978.

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RAILROAD ROLLING STOCK: 5-YEAR AMORTIZATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	−40	−40
1979	------	−40	−40
1978	------	−40	−40

Authorization

Section 184.

Description

Instead of being depreciated on an accelerated basis over its normal useful life, qualified railroad rolling stock placed in service after 1968 and before 1976 could be amortized over a 5-year period using the straight-line method. This election has expired and is no longer available for newly acquired rolling stock. The investment tax credit was not available for property subject to this rapid amortization.

Impact

The use of 5-year amortization for assets having longer actual useful lives benefits the taxpayer by effectively deferring current tax liability (see Appendix A).

After 1971, there was a decline in the use of the 5-year amortization provision which can be explained largely by the reinstatement of the investment tax credit in 1971. The credit in conjunction with accelerated depreciation was generally more advantageous than rapid amortization.

Only railroad companies with taxable income benefit directly from the rapid amortization provision. Railroad companies without taxable income, in effect, sell their right to this rapid amortization to financial companies who initially acquire the rolling stock and then lease it to the railroads. As a result, some of the tax benefits from this provision accrue to lessors that are not railroad companies.

Since this provision has expired, and was used decreasingly in the past few years, the amount of deferred taxes now being paid from earlier years is greater than the current tax savings to those who more recently elected the rapid amortization. As a result, the tax expenditure cost is negative. This reflects the higher taxes now being paid by those taxpayers who previously used the provision, and thus accelerated into earlier years their deductions associated with purchase of the rolling stock.

Rationale

Section 184 was adopted as part of the Tax Reform Act of 1969 when the investment tax credit was repealed. The purposes were to encourage the modernization of railroad equipment, increase railroad efficiency, reduce freight car shortages during seasonal peaks, and aid the financing of new equipment acquisitions.

Selected Bibliography

Benevenutto, Frank A., II. "Lease Rolling Stock and Enjoy Considerable Benefits," *Taxes*, September 1973, pp. 530–36.

DEFERRAL OF TAX FOR SHIPPING COMPANIES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	70	70
1979	------	85	85
1978	------	105	105

Authorization

46 U.S.C. Section 1177 (§ 607 of the Merchant Marine Act of 1936 as amended) and section 46(g) of the Internal Revenue Code.

Description

United States operators of vessels in foreign, Great Lakes, or noncontiguous domestic trade or in U.S. fisheries may establish a capital construction fund (CCF) in which they may deposit income earned by the vessels. Such deposits are deductible from taxable income, and income tax on earnings of deposits in the CCF is deferred.

When such tax-deferred deposits and their earnings are withdrawn from a CCF, no tax is paid if the withdrawal is used for qualifying purposes, such as to construct or acquire a new vessel or to pay off the indebtedness on a qualifying vessel. The tax basis of the vessel (usually its cost to the taxpayer) on which the operator's depreciation is computed is reduced by the amount of such withdrawal. Thus, over the life of the vessel, tax depreciation will be reduced and taxable income will be increased by the amount of such withdrawal, thereby reversing the effect of the deposit. However, since gain on the sale of the vessel and income from the operation of the replacement vessel may also be deposited into the CCF, the tax deferral may be extended indefinitely.

Only withdrawals for purposes other than for construction, acquisition, or payment on indebtedness of a qualifying vessel are taxed at the time of withdrawal, subject to an interest charge for the period during which tax was deferred.

An investment tax credit of one-half the regular credit is allowed for tax deferred amounts withdrawn from CCF's that are used to purchase, construct, or reconstruct qualified vessels.

Impact

Since the inception of this program in the fall of 1971, $1.2 billion has been deposited into CCF's, and $700 million withdrawn.

Rationale

The provision is designed to stimulate American shipbuilding and to recapture some of the foreign yard construction now being done for U.S. companies.

Although tax subsidies of various types have been in existence since 1936, the coverage of the subsidies was expanded substantially by the Merchant Marine Act of 1970.

Prior to the Tax Reform Act of 1976, it was unclear whether the investment tax credit was available for funds withdrawn from a CCF to purchase, construct, or reconstruct qualified vessels. The 1976 Act specifically allowed a one-half investment tax credit to be available in 1976 and subsequent years.

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U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 186–88.

HOUSING REHABILITATION: 5-YEAR AMORTIZATION

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	5	5	10
1979	5	5	10
1978	10	5	15

Authorization

Section 167(k).

Description

In lieu of depreciation, certain expenditures incurred to rehabilitate low or moderate income rental housing may be amortized over 5 years using the straight-line method and no salvage value. This rapid amortization is permitted only with respect to expenditures incurred after July 24, 1969, and before 1979, or if made under a pre-1979 binding contract. Moreover, the write-off is available only where during a period of 2 consecutive years, expenditures exceed $3,000 per unit, and applies only to expenditures not in excess of $20,000 per rental unit. The use of 5-year amortization for assets whose useful lives are longer, benefits the taxpayer by effectively deferring current tax liability (see Appendix A).

Example

Assume a taxpayer spends $10,000 on structural rehabilitation of low or moderate income rental housing with a useful life of 20 years. Without the amortization provision (using the double declining balance method of computing depreciation), his deduction in the first year would be:

$$200 \text{ percent} \times \tfrac{1}{20} \times \$10{,}000 = \$1{,}000$$

In the second year his depreciation would be:

$$200 \text{ percent} \times \tfrac{1}{20} \times \$9{,}000 = \$900$$

The deductions for depreciation would continue in smaller amounts over the remaining life of the asset.

With 5-year amortization, one-fifth of the amount ($2,000) is deducted each year for 5 years. Afterwards, no additional deduction for amortization or depreciation may be taken.

30-560—78——8

Impact

The tax benefit accrues to investors in projects to rehabilitate low and moderate income housing. Even though the properties in question may not be currently earning income, the rapid amortization may be deducted against other income from housing investments, and may provide a tax shelter for totally unrelated income. Low income renters benefit only to the extent that rehabilitated units rent for less than new units of comparable quality, or to the extent that more units are rehabilitated than would be otherwise. The very small amount of evidence available does not indicate a flowthrough of tax benefits to the renters.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	0
10 to 20	0
20 to 30	6.7
30 to 50	13.3
50 and over	80.0

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

This provision was adopted as part of the Tax Reform Act of 1969 as a temporary provision to stimulate rehabilitation of low and moderate income housing. It was subsequently extended for 1 year by P.L. 93-625 (January 3, 1975). Although it expired December 31, 1975, a retroactive reinstatement through 1977 was added in the Tax Reform Act of 1976, which also slightly liberalized the provision as well. The provision was extended again in November 1977 on a temporary basis through the end of 1978.

Selected Bibliography

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———. *Tax Reform*, Hearings, Part 2—Tax Shelters and Minimum Tax, July 16, 1975, pp. 1403–1607.

EXCLUSION OF SCHOLARSHIPS AND FELLOWSHIPS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	355	------	355
1979	330	------	330
1978	295	------	295

Authorization

Section 117.

Description

Generally, individuals may exclude from taxable income amounts received as scholarships or fellowships. The exclusion includes amounts received to cover such incidental expenses as travel, research, clerical assistance, or equipment, but does not apply to any amount received as payment for teaching, research, or similar services. The amount that degree candidates may exclude is unlimited. Scholarships and fellowships for nondegree candidates may be excluded only if the grantors meet certain requirements; further, the amount that they may exclude is limited.

Impact

The value of the tax benefit received by each recipient of a tax exempt scholarship or fellowship grant is small in many cases because grants are of modest amounts and the recipients have little or no tax liability.

However, the amount of the tax benefit increases with the individual's tax bracket, and, therefore, increases with the existence of other income such as a spouse's earnings. Furthermore, university professors often convert sabbatical pay into tax free fellowships.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	49. 0
10 to 20	38. 8
20 to 30	6. 1
30 to 50	4. 1
50 and over	2. 0

Rationale

Prior to the Internal Revenue Code of 1954, scholarships were included in income unless the taxpayer could show that the grant was a gift. This treatment was considered to lack uniformity. The ostensible purpose of the exclusion was to make treatment of taxpayers consistent and uniform. The only amendment to this section, made in 1961 (P.L. 87–256), expanded the category of qualifying grantors of nondegree candidates' scholarships and fellowship grants.

Selected Bibliography

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PARENTAL PERSONAL EXEMPTION FOR STUDENTS AGE 19 OR OVER

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	815	------	815
1979	790	------	790
1978	770	------	770

Authorization

Section 151(e).

Description

A taxpayer is allowed to deduct $750 as an exemption for each dependent. A person with gross income in excess of $750 may not be claimed as a dependent unless that person is the child of the taxpayer and is either (a) less than 19 years of age or (b) a full-time student. Unless support is provided by several taxpayers, a person is a dependent only if the taxpayer claiming him as a dependent provided more than one-half of the person's support.

In addition, for 1978, a taxpayer can take a general tax credit equal to the greater of (1) 2 percent of the first $9,000 of taxable income, or (2) $35 for each personal and dependency exemption.

Impact

This provision benefits families with tax liability and with children who are students and have earnings. The value of each $750 personal exemption deduction is $525 for families with the highest marginal tax rate of 70 percent and $150 for families taxed at the median marginal rate of 20 percent. No relief is available to the parents of students who provide more than one-half of their own support. Therefore, parents are aided by this dependency exemption if their student-children do not rely on their earnings or other income to provide a majority of their support.

The temporary general tax credit adds $35 to the value of each dependency exemption if the exemption alternative is elected by the taxpayer.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	15.3
10 to 20	57.7
20 to 30	5.9
30 to 50	6.0
50 and over	15.1

Rationale

A personal exemption for dependents was first provided by the Revenue Act of 1918, apparently to provide some tax relief for parents supporting young children or students. The definition of a dependent was revised over the years, and a gross income test was added in 1944. The 1954 revision of the Internal Revenue Code eliminated the gross income test for dependent children under the age of 19 and dependent children of any age who were students. Except for increases in the amount of the exemption to $750, this provision has been unchanged since 1954.

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EXCLUSION OF EMPLOYEE MEALS AND LODGING (Other than Military)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	350	------	350
1979	325	------	325
1978	300	------	300

Authorization

Section 119.

Description

Employees exclude from income the value of meals and lodging furnished by the employer on his business premises and for his convenience; the lodging must be required as a condition of employment.

Impact

Meals and lodging furnished by the employer may, in certain cases, constitute a very large portion of the employee's compensation (e.g., in the case of a live-in housekeeper or an apartment resident manager). The value to the employee of such in-kind income in some cases may be difficult to establish. For example, the lodging may simply duplicate rather than substitute for private quarters. The value of the exclusion depends on the value of the income in-kind and the tax bracket of the employee. To the extent that money wages are lower as a result of the tax benefit, employment is subsidized in occupations that involve this type of income in-kind.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	12. 5
10 to 20	50. 0
20 to 30	14. 3
30 to 50	12. 5
50 and over	10. 7

Rationale

The convenience-of-the-employer rule has been in the tax regulations since 1918, presumably in recognition of the problems discussed above. Treatment of such benefits was handled through regulation

and court decisions until 1954. The regulations suggest that immediately prior to the 1954 Act, meals and lodging that were in the nature of compensation (i.e., taken into account in computing salary) were included in income even if they were for the convenience of the employer. The specific statutory language was adopted to end the confusion regarding the tax status of such payments by precisely defining the conditions under which such meals and lodgings were taxable.

Further Comment

The difficulty in many cases in valuing these benefits is cited as a major argument against taxing such benefits. On the other hand, this argument is challenged by others who cite the fact that these payments are valued under the social security law and under many State welfare laws.

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EXCLUSION OF CONTRIBUTIONS TO PREPAID LEGAL SERVICES PLANS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	20	------	20
1979	15	------	15
1978	10	------	10

Authorization

Sections 120 and 501(c)(20).

Description

Amounts contributed by an employer to a qualified group legal services plan for employees, as well as any services received by an employee or any amounts paid to an employee under such a plan as reimbursement for legal services for the employee. are excluded from the employee's income. This exclusion applies to plans established to provide personal legal services for employees, their spouses, and their dependents through prepayment of, or advance provision for, legal fees. Sole proprietors and partners are considered employees for purposes of the exclusion. Plans must be organized through tax-exempt organizations or trusts, or established through insurance companies. To qualify, plans must be nondiscriminatory with respect to enrollment and benefits.

This provision applies to taxable years ending before January 1, 1982. The enacting legislation requires a study to be undertaken by the Departments of the Treasury and Labor about the desirability of continuing these tax benefits. Final reports are to be submitted to the President and the Congress not later than December 31, 1980.

Impact

The tax treatment afforded these plans is similar generally to that provided group life insurance plans and accident and health plans set up by employers for their employees. The value of the exclusion increases with increases in the marginal tax rate of the employee. Group legal programs and similar arrangements were not widely used prior to enactment of these tax provisions in 1976. Although no comprehensive statistics are available, indications are that the number of these plans has grown as a result of the tax incentive.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	20. 0
10 to 20	40. 0
20 to 30	20. 0
30 to 50	20. 0
50 and over	0

Rationale

This tax treatment of group prepaid legal services plans was adopted in 1976 to grant taxpayers some relief from the high cost of legal fees, and to promote the adoption of such plans by employers and employees. Congress believed it was desirable to increase the availability of legal services to middle-income taxpayers whom they considered to be the most under-represented economic group in terms of legal services. Lower income persons have access to publicly supported legal aid services, while higher income taxpayers generally can afford to pay their own legal expenses.

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INVESTMENT CREDIT FOR EMPLOYEE STOCK OWNERSHIP PLANS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	330	330
1979	------	305	305
1978	------	255	255

Authorization

Sections 46(a)(2)(B), 401(a), and 415(c) of the Code, and section 301(d) and 301(e) of the Tax Reduction Act of 1975.

Description

A corporation is allowed an additional investment credit equal to 1 percent of qualifying investment if the corporation contributes an equivalent amount of its own stock to a trust for the benefit of its employees. If both the corporation and its employees contribute a further one-half percent of qualifying investment, a further credit of 1 percent is allowed. Stock contributed under these plans must remain in the trusts for 7 years, after which it can be distributed to the employees.

Employee stock ownership plans consisting of stock acquired as a result of this credit are sometimes referred to as "TRASOP's" (after the Tax Reform Act of 1976 in which the credit was significantly expanded) to distinguish them from ESOP's—employee stock ownership plans involving deductions for employers for direct contributions of their stock as part of a deferred compensation or pension plan. TRASOP's are subject to many of the rules that govern pension plans in general, but are also subject to special rules more favorable to employees than are pension plans generally. For example, in contrast to pension and profit sharing plans which may provide deferred vesting, benefits under TRASOP's immediately vest in the employees.

The provisions allowing these extra credits will expire on December 31, 1980.

Impact

Since a corporation is granted a credit equal to its contribution to a TRASOP, the contribution has no cost to the corporation, and is financed entirely by the Federal Government. By comparison, contributions to regular pension plans or ESOP's are made directly by the employer and resemble wage costs. Furthermore, in contrast to

pension plans in general, only corporate employers are entitled to this additional credit. Employees of sole proprietors and partnerships cannot benefit. The amount of tax benefits is related to investment in property qualifying for the investment credit. The most favored employees are employed in relatively high-capital-intensive and low-labor-intensive industries, because these industries obtain proportionately larger credits per employee.

Although provided in the form of an investment credit, the TRASOP credit has no direct incentive effect on investment, since the value of the additional tax credits must be placed in trust for the employees. The TRASOP provisions can provide a relatively minor direct benefit to corporations which can raise cash by issuing their own stock for transfer to the TRASOP's without the costs of a public offering. In cases in which annual TRASOP stock benefits are very substantial for individual employees, the benefits may partially offset salary payments.

On July 20, 1978, the Treasury Department indicated in a Senate Finance Committee hearing that 1,114 corporations had claimed the TRASOP credit in 1976, with a resulting revenue loss of $439 million. This would indicate that the later year estimates previously developed for this tax expenditure, which are listed above, are too low, and that they will be revised upwards in subsequent tax expenditure budgets. The Treasury indicated that 26 percent of the TRASOP credits were claimed by utilities, which employ only 0.9 percent of all nonagricultural employees, and that 20.2 percent of the credits were claimed by oil and coal corporations, which employ only 0.3 percent of all nonagricultural employees. On the other hand, only 1.1 percent of the credits were claimed by corporations engaged in wholesale and retail trade, which employ 22.2 percent of all nonagricultural employees.

Rationale

A temporary additional investment tax credit for contributions to employee stock ownership plans first was provided by the Tax Reduction Act of 1975 to encourage the growth of these types of plans. The avowed purpose was to provide funds for the purchase of corporate stock by employee trusts allowing employees to share in the ownership of corporate capital and in the growth and profitability of the employer. However, because of the temporary nature of the TRASOP credit and rules which could have resulted in some instances in corporations paying for contributed stock themselves, few plans were established before the 1976 Tax Reform Act. These plans became more widespread with the revisions in the Tax Reform Act of 1976 which extended and expanded the credit in general, and which eliminated any risk of costs of the trusts being borne by employers.

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DEDUCTIBILITY OF CHARITABLE CONTRIBUTIONS

(1) Educational Institutions

(2) Health Institutions

(3) Other Than Educational and Health Institutions

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations		
	Educational	Health	Other	Educational	Health	Other
1980	720	1,075	5,385	315	195	390
1979	645	970	4,855	285	175	350
1978	585	875	4,370	255	160	315

Authorization

Sections 170 and 642(c).

Description

Subject to certain limitations, charitable contributions may be deducted by individuals, corporations, and estates and trusts.

The contributions must be made to specific types of organizations including charitable, religious, educational and scientific organizations, and Federal, State, and local governments.

Individuals who itemize may deduct qualified contributions of up to 50 percent of their adjusted gross income (AGI); however, the deduction for gifts of appreciated property is limited to 30 percent of AGI. In the case of a corporation, the limit is 5 percent of taxable income (with some adjustments).

Impact

The deduction for charitable contributions reduces tax liability, and thus makes the net cost of contributing less than the amount of the gift. In effect, the Federal Government provides the donee with a matching grant which, per dollar of contribution, increases in value with the donor's tax bracket. Thus, a taxpayer in the 70 percent bracket who itemizes deductions can contribute $100 to a charitable organization at a net cost of $30, while one in the 20 percent bracket

can contribute the same amount at a net cost of $80. An individual who takes the standard deduction or a non-taxpayer receives no benefit from the provision.

Types of contributions may vary substantially among income classes. Contributions to religious organizations are far more concentrated at the lower end of the income scale than contributions to hospitals, the arts, and educational institutions, with contributions to other types of organizations falling between these levels. However, the volume of donations to religious organizations is greater than to all other organizations as a group. The volume of giving to educational and health institutions is relatively low.

Organizations that receive the contributions (and their clients) benefit from this provision to the extent it increases charitable giving. Empirical studies have not reached a consensus as to how much the deduction encourages charitable contributions and how the deduction affects the composition of contributions. Tentative conclusions are that the deduction increases charitable giving by more than the foregone Treasury revenue, and that it favors educational and hospital contributions relatively more than religious, health and welfare, and other donees. A tax credit or a matching grant program outside the tax system of equal cost would be expected to reduce the contributions to educational and hospital organizations, while increasing them for other recipients.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	Percentage distributions		
	Educational	Health	Other
0 to 10	0. 4	1. 3	1. 4
10 to 20	3. 2	7. 6	15. 3
20 to 30	4. 8	12. 7	22. 0
30 to 50	18. 3	19. 6	18. 1
50 and over	73. 3	58. 9	43. 2

[1] The distributions refer to the individual tax expenditures only. The corporate tax expenditures resulting from these tax provisions are not reflected in these distribution tables.

Rationale

This deduction was added on the Senate floor in 1917. Senator Hollis, the sponsor, argued that the war and high wartime tax rates had an adverse impact on the flow of funds to charitable organizations. He preferred a tax deduction to a direct Government subsidy. The deduction was extended to estates and trusts in 1918, and to corporations in 1935.

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MAXIMUM TAX ON EARNED INCOME

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	955	------	955
1979	800	------	800
1978	665	------	665

Authorization

Section 1348.

Description

Although marginal tax rates rise to 70 percent, the marginal rate on earned taxable income is limited to 50 percent. The amount of income eligible for this maximum tax provision is computed in several steps as follows:

(1) Earned income that represents compensation for personal services, is reduced by the amount of expense connected with earning it. The remainder is earned net income. (2) The ratio of earned net income to adjusted gross income is then multiplied by total taxable income. The result is taxable earned income. (3) This amount is then reduced by certain tax preference income such as capital gains. (4) The remainder is the amount eligible for the maximum tax on earned income.

The tax rate on other income is not affected.

The maximum tax alternative cannot be used by taxpayers who average income, and may not be used by married individuals filing separate returns.

Impact

This provision reduces the tax rate on high levels of earned income. However, because of the offset for tax preference income, the tax benefit is affected not only by the taxpayer's level of earned income but the extent of his preference income. Each dollar of preference income removes (i.e., offsets) a dollar of earned taxable income otherwise eligible for the maximum tax, and taxpayers with very large amounts of preference income may not benefit much from the provision. Thus, the offset acts as a tax on preference income.

All the tax savings resulting from this preferential rate accrue to taxpayers with $50,000 and more of expanded gross income.

30-560—78——9

Rationale

The maximum tax on earned income was adopted in 1969. Its purpose, as indicated in the House Ways and Means Committee report, was to discourage the use of other tax reducing provisions rather than to provide tax relief. It was argued that a major motivation for tax avoidance was to protect earned income from high tax rates. The Senate Finance Committee, in deleting the amendment, questioned whether it was appropriate to reduce tax rates on earned income while still imposing high tax rates on other income, particularly when the taxpayer could use other devices to avoid high taxes on this other income and use the 50-percent maximum tax provision as well. A reduction for preference income in excess of $30,000, not originally in the House bill, was added in Conference, presumably to respond to these objections.

The Tax Reform Act of 1976 strengthened the effect of the preference income offset by deleting the $30,000 exemption which applied before preference income would reduce income qualifying for the 50 percent rate. The 1976 Act also provided that deferred compensation including pensions and annuities is treated as earned income for purposes of the maximum tax.

Further Comment

In August 1978, the House voted to eliminate capital gains as an item of tax preference subject to the minimum tax. As a result, capital gains would no longer offset the amount of personal service income eligible for the 50 percent maximum tax.

Selected Bibliography

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CREDIT FOR CHILD AND DEPENDENT CARE EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	635	------	635
1979	575	------	575
1978	525	------	525

Authorization

Section 44A.

Description

A taxpayer who maintains a household is allowed a tax credit for employment-related expenses incurred for the care of a dependent child, a disabled dependent, or a disabled spouse. The allowable credit is 20 percent of expenses up to $2,000 (for a maximum credit of $400) annually for one qualifying individual, and up to $4,000 (for a maximum credit of $800) annually for two or more qualifying individuals. No credit is permitted for care outside the home if the dependent is over age 14 or is a spouse. In addition to being available to taxpayers who are employed full-time, the credit is available to married couples where the husband or wife, or both, work part-time, or where one is a full-time student and the other is employed. The credit is permitted for payments to relatives of the taxpayer regardless of whether they live in or outside the taxpayer's household, provided they are not dependents of the taxpayer and are treated as employees for purposes of social security.

Impact

The credit benefits qualified taxpayers with sufficient tax liability to take advantage of the credit, regardless of income or whether they itemize their deductions or take the standard deduction. The credit does not benefit persons with incomes so low that they have no tax liability.

The child care credit was claimed on 2.7 million tax returns for 1976.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	13. 6
10 to 20	43. 6
20 to 30	33. 0
30 to 50	8. 2
50 and over	1. 6

Rationale

The deduction for child and dependent care services first was enacted in 1954. The allowance was limited to $600 per year and was phased out for families with income between $4,500 and $5,100. The intent of the provision was to provide for the deduction of expenses comparable to an employee's business expenses in cases where taxpayers must incur such expenses.

The provision was made more generous in 1964, and was modified in 1971. Several new justifications were specified for the provision in 1971, including encouraging the hiring of domestic workers, encouraging the care of incapacitated persons at home rather than in institutions, providing relief to middle income taxpayers as well as low income taxpayers, and providing relief for employment-related expenses of household services as well as for dependent care. Thus, there was a departure from the earlier intent that only "essential" expenditures for such services should be deductible.

The Tax Reduction Act of 1975 substantially increased the income limits for taxpayers who could claim the deduction.

In 1976, the deduction was replaced by a nonrefundable credit. Congress believed that (1) such expenses should be viewed as a cost of earning income for *all* taxpayers and that it was wrong to deny the benefits to those taking the standard deduction, (2) the tax credit would provide relatively more benefit than the deduction to taxpayers in the lower brackets, (3) the prior rules governing married couples, divorced and separated persons, and payments to relatives were unduly restrictive, and (4) computation of the deduction was too complex.

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CREDIT FOR EMPLOYING AFDC RECIPIENTS AND PUBLIC ASSISTANCE RECIPIENTS UNDER WORK INCENTIVE (WIN) PROGRAM

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	20	20
1979	------	20	20
1978	------	15	15

Authorization

Sections 40, 50A, and 50B.

Description

Employers engaged in a trade or business are allowed a credit against their tax liability equal to 20 percent of the wages paid or incurred with respect to the first 12 months of employment of Federal welfare recipients in the Aid to Families With Dependent Children (AFDC) program who are hired under the Work Incentive Program (WIN). This credit may not exceed $50,000 plus 50 percent of any tax liability over $50,000 in any 1 taxable year. Excess credits may be applied to past and future tax liability; the credit may be carried back 3 years and forward 7 years.

A separate temporary credit is available to employers for 20 percent of wages paid or incurred with respect to the first 12 months of employment of persons receiving assistance under the AFDC program who have *not* participated in the WIN program. The limit on this credit is $25,000 plus 50 percent of any tax liability over $25,000. This temporary credit expires on January 1, 1980.

Impact

Both credits operate as wage subsidies by providing tax relief for employers who hire eligible employees. Participating employees benefit, as does the general taxpayer, to the extent that employment and earnings are increased by the program and welfare payments are reduced. But, other things being equal, individuals not enrolled in this program may be at a disadvantage when seeking employment.

Since the inception of the WIN credit, the percentage of claims made by corporations with assets of $250 million or more has steadily declined. In 1972, this percentage was 60 percent; in 1975, it was 32 percent. In 1975, about 62 percent of corporate claims were made by the manufacturing sector, followed by about 14 percent by wholesale and retail trade businesses.

Based on a survey of State welfare directors, the Senate Finance Committee has indicated that virtually no use has been made of the AFDC credit.

Rationale

WIN was created by Congress in 1967 to encourage private employers to hire and train welfare recipients. The WIN tax credit was created by the Revenue Act of 1971 as added encouragement for employers to hire welfare recipients. It was extended in 1975 temporarily to AFDC welfare payment recipients, regardless of participation in the WIN program, again to encourage employment practices that would reduce welfare payments. The temporary AFDC credit was extended again in November 1977 through the end of 1979.

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NEW JOBS TAX CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	(1)	215	215
1979	860	1,035	1,895
1978	985	1,475	2,460

[1] Less than $2,500,000.

Authorization

Sections 44B and 51–53.

Description

For taxable years 1977 and 1978, an employer may claim a credit equal to 50 percent of the Federal unemployment tax wage base [1] of employees who represent an expansion of his firm's work force. The credit is subject to four major limitations. First, it is available only for increases in the firm's Federal unemployment tax wage base above 102 percent of its base in the previous year. Second, no employer is entitled to more than $100,000 of credits a year. Third, the employer must reduce his deduction under section 162 for wages as ordinary business deductions by the amount of credit claimed. Fourth, the credit may not exceed 25 percent of the firm's total unemployment tax wage base. In addition, in any given year, the credit may not exceed 50 percent of the difference between total wages paid and 105 percent of total wages paid during the previous year.

If the workers qualifying for the new jobs tax credit are mentally or physically handicapped, the employer is entitled to a bonus tax credit equal to 10 percent of the Federal unemployment tax wage base. This bonus credit may not exceed 20 percent of the general credit earned without regard to the $100,000 overall limitation. However, the bonus credit, unlike the general credit, may exceed $100,000 in a year. In other respects, conditions imposed on the two credits are identical.

Example

Corporation A employed 10 workers in 1976, paying each $10,000. In 1977, it employed 20 workers, paying each $15,000. A has a marginal

[1] The Federal unemployment insurance tax wage base was $4,200 for 1977. For 1978, the unemployment tax wage base increased to $6,000 per employee. However, the new jobs tax credit maintains the $4,200 wage base for calculating the credit in 1978. This wage base also applies to agricultural and railroad employees who are not part of the Federal Unemployment Tax Act (FUTA) system.

Federal income tax rate of 48 percent. A's credit for 1977 would be calculated as follows:

(1) 1976 Federal unemployment tax wage base	10×$4,200=$42,000
(2) $42,000×1.02	$42,840
(3) 1977 Federal unemployment tax wage base	20×$4,200=$84,000
(3) minus (2)	$41,160

Therefore, the credit equals 50 percent of $41,160, or $20,580.

A must reduce its deduction for wages as ordinary business expenses by the amount of credit claimed. This increases A's taxes by $9,878.40 (.48×$20,580) before the credit is subtracted. The new jobs tax credit therefore results in a net reduction in A's taxes of $20,580 minus $9,878.40, or $10,701.60.

Impact

The tax benefits from the credit per eligible new employee are inversely proportional to the income tax bracket of the employer. For each eligible employee who earns at least the $4,200 salary on which the credit is based, an employer in the lowest marginal income tax bracket (14 percent) saves $1,806. An employer in the highest marginal bracket (70 percent) saves $630. A corporation subject to tax at the 48 percent marginal tax rate saves $1,092. The tax savings per eligible handicapped employee from both the general and bonus credits are $2,167.20 for an employer with a 14-percent marginal tax rate, $756 for an employer with a 70-percent marginal tax rate, and $1,310.40 for a corporation with a 48-percent marginal tax rate.

Since in most cases the maximum annual credit per firm is $100,000, in general, only the first 47 employees over 102 percent of the firm's past year's employment fully qualify.

By reducing the costs of hiring marginal employees, the credit can make a difference whether it will be profitable to hire new employees. For example, assume a job candidate who could contribute $6,000 to the income of a sole proprietorship requires an annual salary and other costs of $7,400. If the proprietor's marginal tax rate is 30 percent, and the Federal unemployment tax wages of the candidate are fully eligible for the credit, the credit reduces the cost of hiring the candidate to $5,930. At this cost, it would become profitable to hire him with the existence of the credit.

Because the credit has been so recently enacted, no data have yet been generated to evaluate its impact and the distribution of its benefits by region, industry, or firm size. One would expect, however, that the credit would be utilized most extensively by labor-intensive industries experiencing high rates of growth, such as construction, wholesale and retail trade, furniture, fabricated metals, and services. On the other hand, some firms with stable or declining employment are prevented by the 102 percent base from using the credit for hiring additional employees they otherwise would not have hired. Industries confronted with this limitation on a broad scale include railroads, textile mills, and leather and leather products. Similarly, firms located in stable or declining regions, such as the Northeast and North-Central regions, would have relatively more difficulty taking advantage of the credit. On the other hand, rapidly growing regions, such as the South and Southwest, should obtain a disproportionate share of the credit's benefits.

The distribution of benefits from the credit by firm size is difficult to predict. On the one hand, large firms are constrained by the $100,000 overall limitation. On the other hand, the credit's complexity might deter small firms from taking advantage of it. Furthermore, firms, particularly rapidly growing ones, might be impeded by the limitation of the credit to 25 percent of total Federal unemployment tax wages. Consider a firm with three employees, each paid $10,000 per year. Total Federal unemployment tax wages for the firm are 3 × $4,200, or $12,600. If the firm could claim full credits for filling two additional positions, it would claim 2 × $2,100, or $4,200. However, it cannot claim credits worth more than 25 percent of $12,600, or $3,150.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	8.0
10 to 20	24.0
20 to 30	18.4
30 to 50	20.0
50 and over	29.6

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from these tax provisions is not reflected in this distribution table.

Rationale

Enacted in the Tax Reduction and Simplification Act of 1977, the credit is designed to reduce unemployment. By limiting the credit to net new employees, Congress intended to focus the incentive as much as possible on employment that would not occur in the credit's absence. The use of 102 percent of FUTA wages in the previous calendar year as the credit's base indicates a similar concern for maximizing the credit's cost-effectiveness. Implicit in this formula is the assumption that on the average a firm's number of employees will increase at least at an annual rate of 2 percent without the credit.

The limitation of the credit to 50 percent of the excess of total wages over 105 percent of the previous year's wages is intended to prevent employers from benefiting from the conversion of existing full-year full-time jobs into new part-year or part-time jobs. The requirement that wage and salary deductions must be reduced by the value of the claimed credit is designed to prevent the use of the credit as a tax-shelter device.

Further Comment

In August 1978, the House approved a targeted jobs credit to replace the temporary new jobs tax credit. The House provision as well as a somewhat similar Administration proposal would limit benefits to employers that hired disadvantaged individuals, principally poor youth between 18–24 years of age. Compared to the existing credit, these proposals would not preclude any businesses from fully participating in the program because of either a maximum credit per employer or a relatively high incremental wage base.

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EXCLUSION OF EMPLOYER CONTRIBUTIONS FOR MEDICAL INSURANCE PREMIUMS AND MEDICAL CARE

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	8, 240	------	8, 240
1979	7, 225	------	7, 225
1978	6, 340	------	6, 340

Authorization

Section 106.

Description

Employees do not pay tax on their employers' contributions to accident and health plans which provide compensation for sickness and injury.

Impact

The exclusion for the employer's contribution to employee health insurance plans benefits all taxpayers who participate in a plan. Because of the exemption, employers can provide the insurance coverage at less cost than they would have to pay in taxable wages for employees to purchase an equal amount of insurance. Thus, in effect, the provision reduces the employee's net after-tax price of obtaining health insurance and health services. The exclusion is worth more the higher the taxpayer's marginal tax rate.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	10. 5
10 to 20	33. 1
20 to 30	27. 8
30 to 50	15. 9
50 and over	12. 7

Rationale

Prior to the adoption of the Internal Revenue Code of 1954, amounts paid by employers for group employee insurance were excluded from gross income of the employee. However, amounts paid for individual policies were included. Section 106 equalized the tax treatment of contributions to the various funds by exempting them all.

While the objective of the original group policy exemption is not clear, the current treatment is justified as indirect Federal assistance to help pay for the health insurance of taxpayers.

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DEDUCTIBILITY OF MEDICAL EXPENSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	2,895	------	2,895
1979	2,655	------	2,655
1978	2,435	------	2,435

Authorization

Section 213.

Description

Medical expenses paid by an individual including medical insurance premiums may be itemized and deducted from income to the extent they exceed 3 percent of adjusted gross income (AGI). In computing medical expenses, amounts paid for medicine and drugs may be taken into account only to the extent they exceed 1 percent of AGI. In addition, the 3 percent floor notwithstanding, an amount—not in excess of $150 per year—equal to one-half of medical insurance premiums for the year may be deducted.

Impact

For taxpayers who itemize their deductions, this provision reduces the net (after-tax) price of health services in excess of the applicable AGI percentage floors, as well as the price of health insurance. The deduction is worth more the higher the taxpayer's marginal tax rate.

The Treasury Department estimated that in 1978 the average taxpayer will spend approximately 8 percent of income on medical expenses. Thus, while the 3 percent floor restricts the use of the deduction to offset medical expenses generally, it allows medical deductions by substantial numbers of taxpayers whose expenses are average or lower than average.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	6.0
10 to 20	31.7
20 to 30	28.4
30 to 50	18.3
50 and over	15.6

Rationale

Health costs in excess of a given floor were first allowed as a deduction in 1942 in order to maintain high standards of public health and to ease the burden of high wartime tax rates. Originally, the deduction was allowed only to the extent that medical expenses exceeded 5 percent of AGI (considered to be the average family medical expense level), and was subject to a $2,500 maximum. In 1951, the floor was removed for taxpayers 65 or over. In 1954, when the Internal Revenue Code was substantially revised, the percentage of AGI was reduced to 3 percent and the 1 percent floor was imposed on drugs and medicines. The dollar ceiling was increased several times until it was finally eliminated in 1965. In that year, the aged were made subject to the floor and the partial deduction for health insurance premiums was allowed without a floor. Since insurance premiums help to even out health expenditures and make it less likely that such expenses can be deducted, it was reasoned that half the cost of insurance premiums should be outside the floor to prevent the tax system from discouraging the purchase of health insurance.

Further Comment

Tax deductions and exclusions related to health care may affect the pattern of purchase of medical services, particularly the purchase of medical care through insurance. While tax subsidies for medical care provide financial relief for some taxpayers who itemize significant medical expenses (the relief being greater the higher the tax bracket), at the same time, these subsidies may encourage the purchase of medical services, and thus contribute to the bidding up of prices for those services. However, alternative programs to provide national health insurance also might result in bidding up the price of these services.

The House voted in August 1978 to repeal the itemized deduction for one-half of the cost of medical insurance premiums up to $150 apart from the general limitation that medical expenses and premiums are deductible only in excess of 3 percent of adjusted gross income. The House also agreed to repeal the special limitation that permits the deduction of medicine and drug costs only to the extent they exceed 1 percent of adjusted gross income.

Selected Bibliography

Davis, Karen. *National Health Insurance: Benefits, Costs, and Consequences*, The Brookings Institution, Washington, D.C., 1975.

Feldstein, Martin, and Elizabeth Allison. "The Tax Subsidies of Private Health Insurance: Distribution, Revenue Loss and Effect," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 8—Selected Subsidies, July 29, 1974, pp. 977–94.

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 156–60.

Mitchell, B. M., and R. J. Vogel. *Health and Taxes: An Assessment of the Medical Deduction*, R–1222–OEO, The Rand Corporation, Santa Monica, Calif., August 1973.

DEDUCTION FOR ELIMINATING BARRIERS TO THE HANDICAPPED

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	(1)	(1)
1979	------	10	10
1978	------	10	10

[1] Less than $2,500,000.

Authorization

Section 190.

Description

For taxable years ending before 1980, a taxpayer may elect to treat certain expenses for the removal of architectural and transportational barriers as deductible expenses instead of capitalizing them. The maximum deduction for any taxable year is $25,000.

Impact

Generally, expenditures that improve assets must be capitalized and deducted over the useful life of such improvements. The tax advantage of treating these expenditures as current expenses amounts to an interest-free loan. Since the provision has only recently been enacted, it is not yet clear whether it is, in fact, accomplishing its goal.

Rationale

The Architectural Barriers Act of 1968 and other Federal legislation dealing with the problem of architectural and transportational barriers to the handicapped (principally involving requirements under Federal contracts or federally funded facilities) were believed to have had an insufficient impact on the removal of such barriers by business and industry. In 1976, this tax incentive was adopted to promote more rapid modification of business facilities and vehicles. The removal of the barriers to the handicapped and elderly is expected to increase their involvement in economic, social, and cultural activities. The deduction is limited to a 3-year period in order that Congress may review its cost effectiveness before the program is in effect for many years.

Selected Bibliography

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 639–40.

EXCLUSION OF SOCIAL SECURITY BENEFITS

Disability Insurance Benefits, OASI Benefits for the Aged, and Benefits for Dependents and Survivors

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations	Total
	Disability insurance benefits	OASI benefits for aged	Benefits for dependents and survivors		
1980	685	5,165	1,160	------	7,010
1979	605	4,700	1,040	------	6,345
1978	550	4,210	950	------	5,710

Authorization

I.T. 3194, 1938–1 C.B. 114 and I.T. 3229, 1938–2136, as superseded by Rev. Rul. 69–43, 1969–1 C.B. 310; I.T. 3447, 1941–1 C.B. 191, as superseded by Rev. Rul. 70–217, 1970–1 C.B. 12.

Description

Social security benefits to persons who are aged, disabled, or the widow or widower of a spouse who participated in the system, are not included in gross income and thus are tax exempt.

Impact

The elderly benefit most from this treatment, since most social security payments are made to the elderly. The tax saving per dollar of exclusion increases with the marginal rate of the taxpayer. Therefore, the exemption is worth much less to a recipient whose income comes solely from social security benefits, than to recipients with substantial amounts of taxable income.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	Percentage distributions		
	Disability insurance benefits	OASI benefits for aged	Benefits for dependents and survivors
0 to 10	56.8	56.6	56.6
10 to 20	23.4	23.4	23.4
20 to 30	9.6	9.5	9.5
30 to 50	6.8	6.7	6.7
50 and over	3.4	3.8	3.7

30-560—78——10

Rationale

The exemption for social security payments has never been established by statute; it derives from administrative ruling I.T. 3447, issued in 1941. A Supreme Court decision in 1937 and a 1938 IRS ruling regarding lump sum payments may have been influential in resolving the issue. In 1937, the Supreme Court characterized social security as "general welfare" (*Helvering* v. *Davis*, 301 U.S. 619, 640). Two 1939 rulings made lump sum distributions nontaxable (I.T. 3194 and I.T. 3229); internal memoranda suggested that the payments were considered in the nature of a gift. The reasons underlying the 1941 IRS ruling on monthly payments appear to include: (1) the benefits are gratuities and thus not subject to income tax because gifts are not taxable; (2) Congress indicated its intent that the benefits not be taxable since it did not specifically make them taxable; and (3) the benefits are in the nature of public assistance for the general welfare and Congress did not intend to tax with one hand what it pays out with the other.

Further Comment

There have been proposals to include these payments in taxable income to the extent payments exceed employee contributions, and to adjust allowances, such as the personal exemption and standard deduction, to afford tax relief to persons below a determined income level. However, the distribution of net (after-tax) benefits would generally differ from the distribution of nontaxable benefits. Therefore, if benefits were to be made taxable, the benefit structure might require adjustment. There also could be substantial administrative difficulties in taxing the portion of the benefits which exceeded employee contributions.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 103–07.

Groves, Harold. *Federal Tax Treatment of the Family*, Chapter III—Tax Treatment of the Aged and Blind, The Brookings Institution, Washington, D.C., 1963.

EXCLUSION OF RAILROAD RETIREMENT BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	295	------	295
1979	280	------	280
1978	265	------	265

Authorization

45 U.S.C. 228, Railroad Retirement Act of 1935, as amended.

Description

Benefits paid under the Railroad Retirement Act are tax exempt.

Impact

This exclusion benefits retired members of the Railroad Retirement System. Payments generally are larger than those under social security.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	56. 8
10 to 20	23. 2
20 to 30	9. 6
30 to 50	6. 8
50 and over	3. 6

Rationale

While this exclusion has a statutory foundation, the reasons supporting it have not been stated. Presumably they are similar to those stated for social security. (See p. 138.)

Further Comment

The questions relating to tax treatment of railroad retirement benefits are similar to those arising in connection with social security benefits. (See p. 138.)

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 103–07.

Groves, Harold. *Federal Tax Treatment of the Family*, Chapter III—Tax Treatment of the Aged and Blind, The Brookings Institution, Washington, D.C., 1963.

EXCLUSION OF WORKERS' COMPENSATION BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1,115	------	1,115
1979	970	------	970
1978	835	------	835

Authorization

Section 104(a)(1).

Description

Workers' compensation benefits are not taxable.

Impact

The provision reduces tax burdens during periods of illness. It also exempts benefits for permanent injuries. The benefit amounts are specified by State law (in contrast to the sick pay exclusion, where payments are subject to the employer's discretion).

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	56.7
10 to 20	23.5
20 to 30	9.4
30 to 50	6.7
50 and over	3.7

Rationale

A rationale for this provision is not offered in the committee reports accompanying its enactment in 1918.

Further Comment

The level of workers' compensation is specified by law and is related to salary level. Minimum and maximum benefits levels apply. Payments are based on degree of disability, and may be related to family size, but not to the amount of other family income. If the benefits were made taxable, their level and structure might require adjustment.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 107–09.

Wentz, Roy. "An Appraisal of Individual Income Tax Exclusions," in U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, Committee Print, 1959, pp. 329–40.

EXCLUSION OF SPECIAL BENEFITS FOR DISABLED COAL MINERS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	50	------	50
1979	50	------	50
1978	50	------	50

Authorization

30 U.S.C. 801 and Revenue Ruling 72–400, 1972–2 C.B. 75 (under Section 104(a)(1) of the Internal Revenue Code).

Description

Payments made to coal miners or their survivors for death or disability resulting from pneumoconiosis (black lung disease) under the Federal Coal Mine Health and Safety Act of 1969, as amended by the Black Lung Benefits Act of 1972 and the Black Lung Benefits Reform Act of 1977, are exempt from income tax.

There are two types of black lung programs. The first involves Federal payments to coal miners and their survivors due to death or disability, payable for claims filed before December 31, 1972. Benefits are related to the GS–2 civil service pay scale and number of dependents. The benefits scale rises from payments of $219.90 for a disabled miner without dependents to $439.70 for a miner with three or more dependents. This program currently provides total annual payments of around $1 billion to approximately 500,000 beneficiaries.

The second program requires coal mine operators to insure payment of black lung benefits in a federally mandated workers' compensation program. Benefits include medical treatment as well as cash payments. These benefits are paid from a trust fund financed by a tax on coal production if there is no responsible operator (an operator for whom the miner worked 1 year). Total annual payments are relatively small—less than $50 million—under this program at present.

Impact

The black lung payments specified in the Federal payment schedule are generally too low by themselves to subject the recipients to tax liability. Therefore, those who benefit from the exclusion are likely to be recipients with other employment or with working spouses.

In fact, one criticism of the black lung benefit program is that benefits continue even though recipients are working in some other occupation.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	58. 0
10 to 20	24. 0
20 to 30	10. 0
30 to 50	6. 0
50 and over	2. 0

Rationale

Payments made as a result of claims filed before December 31, 1972, were specifically excluded from Federal income tax by the Black Lung Benefits Act of 1972. Later payments are excluded by revenue ruling because they are considered to be in the nature of workers' compensation.

Selected Bibliography

U.S. Library of Congress. Congressional Research Service. "Black Lung Benefits—A Brief Legislative History," by Bob Guttman, Multilith 76–194ED, Oct. 20, 1976.

Walter, Douglas H. "Tax Changes Effected by the Black Lung Benefits Revenue Act of 1977," *Taxes*, May 1978, pp. 251–54.

EXCLUSION OF UNEMPLOYMENT INSURANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1,090	------	1,090
1979	1,135	------	1,135
1978	1,200	------	1,200

Authorization

I.T. 3230, 1938–2 C.B. 136; Rev. Rul. 70–280, 1970–1 C.B. 13.

Description

Taxpayers may exclude unemployment compensation benefits from gross income; thus these benefits are not taxed.

Impact

The tax benefit from this provision depends upon the amount of unemployment compensation received, and the tax savings per dollar of tax exempt income increases with the taxpayer's marginal income tax bracket. Therefore, the exemption is of little value to a recipient with no other sources of income, but of increasing value to taxpayers with either substantial investment income, a spouse who earns a substantial salary, or a high salary they earned themselves during the part of the year they were employed.

Some lower income taxpayers are ineligible for unemployment compensation programs because they have worked in occupations not covered by unemployment insurance or for too short a period to qualify for the payments.

A recent study cited below noted that in 1970 unemployment benefits averaged about two-thirds of net earnings (i.e., earnings minus social security and other Federal, State, and local taxes). Benefits that are high relative to net earnings because they are tax exempt offer a better cushion against financial hardship during unemployment, but at the same time they may discourage the seeking of new employment. Taxation of the benefits might reduce this disincentive effect for some of the recipients with substantial amounts of taxable income.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	36. 7
10 to 20	39. 7
20 to 30	14. 9
30 to 50	5. 3
50 and over	3. 4

Rationale

There is no statutory basis for this provision. The decision to exempt unemployment compensation benefits from income taxation was made administratively by the Treasury Department in a 1938 ruling

Further Comment

In August 1978, the House voted to tax a portion of unemployment compensation benefits received by married individuals filing a joint return with over $25,000 of adjusted gross income, and received by other individuals with over $20,000 of adjusted gross income.

Selected Bibliography

Feldstein, Martin. "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal*, June 1974, pp. 231–44.

EXCLUSION OF PUBLIC ASSISTANCE BENEFITS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	380	------	380
1979	360	------	360
1978	345	------	345

Authorization

No general statutory authorization. A number of revenue rulings under section 61 have declared specific types of public assistance payments excludable.

Description

Individuals may exclude public assistance payments from income; thus the payments are tax exempt.

Impact

Because of the relatively low level of public assistance payments and other income of recipients, most individuals who receive these payments would have no income tax liability even if the payments were taxable. Those who do benefit from the exclusion tend to be those who receive high public assistance payments or who receive public assistance during part of the year and are employed the remainder. There is no conclusive evidence that the tax treatment affects the recipients' incentive to work.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	78. 5
10 to 20	15. 5
20 to 30	5. 1
30 to 50	0. 9
50 and over	0

Rationale

Revenue rulings generally exclude government transfer payments from income because they are considered to be general welfare payments. While no specific rationale has been advanced for this exclusion, the reasoning may be similar to that for social security payments—that they are in the nature of gifts, and that Congress did not intend to tax with one hand what it pays out with the other.

Further Comment

Perhaps the major question involved in the tax treatment of public assistance payments is whether they should be excluded from taxable income or whether exemptions in the tax law designed to remove low-income individuals from the tax rolls are sufficient. Thus, if the present level of exemptions reflects a general agreement on an income level below which taxes are not to be paid, a case might be made for including public assistance payments in income, just as are other receipts.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 100–03.

EXCLUSION OF SICK PAY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	65	------	65
1979	60	------	60
1978	75	------	75

Authorization

Section 105(d).

Description

Individuals under age 65 who have retired on disability and are permanently and totally disabled are entitled to a maximum exclusion from income of $100 a week ($5,200 a year) of qualified payments received because of the disability. These payments must be received by employees (but not self-employed individuals) under accident and health plans financed wholly or partially by employers. The excludable amount must be reduced on a dollar-for-dollar basis by the amount the taxpayer's adjusted gross income (including disability income) exceeds $15,000.

Impact

The exclusion of disability payments is designed to reduce the tax burden of individuals under age 65 who receive such payments and are unable to continue working. The adjusted gross income phaseout focuses relief on low- and middle-income taxpayers. At age 65, taxpayers become ineligible for the disability payments exclusion, but are eligible for the tax credit for the elderly.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	15. 4
10 to 20	59. 1
20 to 30	12. 7
30 to 50	7. 3
50 and over	5. 4

Rationale

From 1954 to 1976, certain amounts received under wage continuation plans when an employee was absent from work on account of personal injury or sickness were excluded from income. The purpose was to equalize the treatment of employer-financed sick pay plans with the treatment of plans administered by insurance companies. In

1976, the prior law was substantially revised because of: (1) the inequity in the tax treatment of sick employees compared to working ones (sick pay in lieu of wages was exempt from tax while the same payments if made as wages were taxed); (2) the inequity in the distribution of the benefits (low- and middle-income taxpayers received lower tax benefits than higher income taxpayers on the same amounts of excludable sick pay because of the progressive rate structure); and (3) complexity.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 107–09.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 127–29.

Wentz, Roy. "An Appraisal of Individual Income Tax Exclusions," in U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, Committee Print, 1959, pp. 329–40.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Employer Plans

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	12, 925	------	12, 925
1979	11, 335	------	11, 335
1978	9, 940	------	9, 940

Authorization

Sections 401–407, 410–415.

Description

Employer contributions to qualified pension, profit-sharing, stock bonus, bond purchase, and annuity plans on behalf of an employee are not taxable to the employee at the time they are made. The employer generally receives a current deduction for these contributions. The earnings on the plan's assets are not taxed until distributed. The employee is taxed at the time he begins to receive benefits under the plan (with appropriate adjustments where he has contributed). For this treatment to apply, the plan must be "qualified," i.e., it must satisfy certain requirements including nondiscrimination, vesting, and funding.

Impact

The tax expenditure is composed of two elements: (1) the average employee's marginal tax rate will be lower during his retirement years than during his working life because of lower income and special tax provisions for the aged; and (2) current aggregate pension contributions and investment income which are not taxed exceed aggregate amounts paid out as taxable benefits.

Once an employee's rights to a pension become nonforfeitable, he enjoys a tax deferral which is the equivalent of an interest free loan. There are conflicting views concerning whether employers also enjoy tax deferral. Their deductions may be viewed as accelerated from the time the employee's rights become nonforfeitable to the time at which the contributions are made. Under this view, the employer's liability is to pay pensions when due, and making the contribution amounts to

a shifting of the form of the employer's assets. On the other hand, it is argued that the employer's deduction is not accelerated because the contribution discharges a current expense, the pension cost for the current period.

The employees who benefit from this provision are primarily middle and upper income taxpayers whose employment has been sufficiently continuous for them to qualify for benefits in a company or union-administered plan. Lower income employees also benefit proportionately less from this tax expenditure because a significant number of employer plans are integrated with the social security system. Under these plans, social security contributions and benefits are counted in determining whether the plans discriminate in favor of officers, shareholders, or highly paid persons.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	5.2
10 to 20	29.2
20 to 30	29.9
30 to 50	19.2
50 and over	16.5

Rationale

This basic treatment was adopted initially in 1921. It was apparently designed to encourage employers to establish retirement programs.

Further Comment

The Carter Administration proposed in 1978 that the rules governing the extent to which plans may be integrated with social security be tightened so that relatively increased contributions and benefits would be provided for lower income employees.

Selected Bibliography

"New Developments in Tax Administration and Pension Plans—Symposium," *National Tax Journal*, September 1974.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform*, Panel Discussions, Part 7—Pensions, Profit Sharing, and Deferred Compensation, 93d Cong., 1st sess., Feb. 22, 1973.

U.S. Congress. Senate. *Employee Retirement Income Security Act of 1974*, S. Rept. No. 93–1090, 93d Cong., 2d sess., Aug. 13, 1974, pp. 343–56.

U.S. Department of the Treasury. *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*, Jan. 30, 1978, pp. 147–63.

NET EXCLUSION OF PENSION CONTRIBUTIONS AND EARNINGS

Plans for Self-Employed and Others

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	2, 205	------	2, 205
1979	1, 920	------	1, 920
1978	1, 650	------	1, 650

Authorization

Sections 219–220, 401–405, 408–415.

Description

Self-employed individuals may deduct from gross income 15 percent of their earned income or $7,500 a year, whichever is less, for contributions to a qualified tax-exempt retirement plan. Regardless of the 15 percent limitation, a self-employed individual may deduct a minimum of $750 annually.

An employee not covered by a qualified private retirement plan or a governmental plan may set up a tax-exempt individual retirement account (IRA) to which annual tax deductible contributions up to the lesser of 15 percent of earned income or $1,500 may be made.

A married taxpayer who is eligible to set up an IRA is permitted to make deductible contributions to an IRA for the benefit of the nonworking spouse. The maximum combined annual contribution for both spouses to the two IRA's is 15 percent of earned income or $1,750, whichever is less.

Distributions from these retirement plans are included in income for tax purposes.

Impact

These provisions, like those for employer plans, allow deferral of tax liability both on the deductible contributions themselves and the earnings of the fund. This is equivalent to an interest-free loan. In addition, when the individual receives payments from the fund, he is likely to be in a lower tax bracket than during his earning years due to the probability of reduced income and the existence of other tax provisions which reduce the tax liability of the elderly and retired.

The tax benefits of self-employed plans are enjoyed more by higher income individuals than are those of employer plans because professional and other higher income self-employed individuals are more likely to be able to set aside the maximum contribution amounts.

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The income levels of taxpayers benefitting from IRA's are comparable to those of taxpayers benefitting from employer plans. The primary beneficiaries are those in the middle and upper income classes.

The extent to which self-employed plans and IRA's encourage more saving, rather than changing the form in which the wealth is held, is uncertain.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2. 4
10 to 20	13. 7
20 to 30	19. 1
30 to 50	25. 1
50 and over	39. 6

Rationale

The tax benefits for self-employed individuals are intended to provide treatment similar to that afforded employees securing benefits under employers' qualified plans. This legislation was enacted in 1962. It was considerably liberalized in 1974 when the provision for individual retirement accounts (IRA's) was enacted. The purpose of IRA's was to eliminate the discrimination against employees not covered by pension plans. In 1976, the benefits of an IRA program were extended to a limited degree to the nonworking spouse of an eligible employee. It was thought to be unfair that the nonworking spouse of an employee eligible for an IRA did not have access to a tax-deferred retirement program, since this spouse performs valuable household work.

Further Comment

Several questions continue to be raised apart from the basic issue of a tax exclusion for saved income: Should the dollar limitation on self-employed plans differ from that of the individual retirement accounts? Should the dollar limitations on these plans be below the maximum amounts allowed corporations? Should those covered by employer plans be allowed to deduct the difference between their employer's contribution and the maximum limitations provided in the law? Should the self-employed and corporate employees be permitted to establish retirement programs for their nonworking spouses?

Selected Bibliography

Anreder, Steven S. *How To Retire Rich Before Sixty*, Farnsworth, New York, 1977.

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform*, Panel Discussions, Part 7—Pensions, Profit Sharing, and Deferred Compensation, 93d Cong., 1st sess., Feb. 22, 1973.

U.S. Congress. House. Committee on Ways and Means. *Survey Report on Individual Retirement Accounts*, Committee Print, 94th Cong., 1st sess., Nov. 17, 1975.

U.S. Library of Congress. Congressional Research Service. "Limitations on Private Pension Benefits and Contributions—Problems in Establishing Equitability," by Ray Schmitt, Multilith 75-162ED, July 11, 1975.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Group Term Life Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1,010	------	1,010
1979	955	------	955
1978	905	------	905

Authorization

Section 79 and L.O. 1014, 2 C.B. 8 (1920).

Description

Employer payments of employee group term life insurance premiums for coverage up to $50,000 are not included in income by the employee. Since life insurance proceeds are not subject to income tax, the value of this fringe benefit is never subject to income tax.

Impact

These insurance plans, in effect, provide additional income to employees. Since neither the value of the insurance coverage nor the insurance proceeds are taxable, this income can be provided at less cost to the employer than the gross amount of taxable wages which would have to be paid to employees to purchase an equal amount of insurance. Group term life insurance is a significant portion of total life insurance covering over 100 million policies and accounting for over 40 percent of all life insurance in force. Individuals who are self-employed or who work for an employer without such a plan do not have the advantage of this tax subsidy for life insurance protection.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	10.5
10 to 20	33.1
20 to 30	27.8
30 to 50	15.9
50 and over	12.7

Rationale

This exclusion was originally allowed, without limitation as to coverage, by administrative legal opinion (L.O. 1014, 2 C.B. 8 (1920)). The reason for the ruling is unclear, but it may have related to supposed difficulties in valuing the insurance to individual employees since the value is closely related to age and other mortality factors. Studies later indicated valuation was not a problem. The limit on the amount subject to exclusion was enacted in 1964. Reports accompanying that legislation reasoned that the exclusion would encourage the purchase of group life insurance and assist in keeping the family unit intact upon death of the breadwinner.

Selected Bibliography

American Council of Life Insurance. *The Life Insurance Fact Book*, Washington, D.C., 1977.

U.S. Congress. House. Committee on Ways and Means. *Hearings on President's 1963 Tax Message*, 88th Cong., 1st sess., 1963, pp. 108–13.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Premiums on Accident and Accidental Death Insurance

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	85	------	85
1979	80	------	80
1978	75	------	75

Authorization

Section 106.

Description

Premiums paid by employers for employee accident and accidental death insurance plans are not included in the gross income of employees and, therefore, are not subject to tax.

Impact

As with term life insurance, since the value of this insurance coverage is not taxable, the employer would have to pay more in wages, which are taxable, to confer the same benefit on the employee. Employers thus are encouraged to buy such insurance for employees. Insurance awards to employees for accidents and accidental death are generally exempt from income tax.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	10. 0
10 to 20	34. 3
20 to 30	27. 1
30 to 50	15. 7
50 and over	12. 9

Rationale

This provision was enacted in 1954. Previously, only payments for plans contracted with insurance companies could be excluded from gross income. The committee report indicated this provision equalized the treatment of employer contributions regardless of the form of the plan.

Selected Bibliography

Guttentag, Joseph F., E. Deane Leonard, and William Y. Rodewald. "Federal Income Taxation of Fringe Benefits: A Specific Proposal," *National Tax Journal*, September 1953, pp. 250–72.

Wentz, Roy. "An Appraisal of Individual Income Tax Exclusions," in U.S. Congress, House, Committee on Ways and Means, *Tax Revision Compendium*, Committee Print, 1959, pp. 329–40.

EXCLUSION OF OTHER EMPLOYEE BENEFITS

Privately Financed Supplementary Unemployment Benefits

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	10	------	10
1979	10	------	10
1978	10	------	10

Authorization

Section 501(c)(17).

Description

Employer payments into a qualified supplementary unemployment insurance benefit trust are not taxable income to the employees when paid into the trust, nor are the earnings of the trust fund taxable as they accrue. The payments into the fund are deductible as business expenses by the employer. Benefits paid out are taxable to employees only upon receipt.

Impact

The employer contributions and trust fund earnings provide a fringe benefit for the employees equivalent to unemployment insurance coverage for each employee. As in the case of insurance premiums paid by employers to cover their employees, the employer would have to pay more in wages which would be taxable, to confer the same value of benefits on the employees as he does by making payments into these qualified benefit trusts.

Such plans are particularly attractive in industries affected by cyclical unemployment. Data collected in the mid-sixties indicated that these plans were concentrated primarily in the auto, steel, garment, and rubber industries.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	30.0
10 to 20	40.0
20 to 30	20.0
30 to 50	10.0
50 and over	0

Rationale

The specific exemption relating to such plans (section 501(c)(17)) was enacted in 1960. However, most of such plans could also qualify for exemption under section 501(c)(9), predecessors of which have been in the tax law since its inception. The section 501(c)(17) exemption was made to allow the qualification of plans that did not otherwise qualify under section 501(c)(9), primarily because of limitations on investment income.

Selected Bibliography

U.S. Department of Labor. "Major Collective Bargaining Agreements—Supplemental Unemployment Benefit Plans and Wage-Employment Guarantees," Bulletin No. 1425–3, June 1965, p. 108.

EXCLUSION OF INTEREST ON LIFE INSURANCE SAVINGS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	2, 450	------	2, 450
1979	2, 225	------	2, 225
1978	2, 025	------	2, 025

Authorization

Section 101(a) and case law interpreting Treas. Reg. 1.451–2.

Description

Most life insurance policies, other than term policies, accumulate interest-bearing reserves which benefit the policyholder by, in effect, reducing his premiums. However, this interest is not included in the policyholder's income for tax purposes as it accumulates. Pursuant to section 101(a), policy proceeds paid because of the death of the insured usually are not included in income. Therefore, when policy proceeds are not taxed at death, the previously accumulated interest is not taxed at all. If a policy is surrendered before death, only the excess of the cash surrender value over the premiums paid is included in income, with the result that the cost of the current insurance and initial expense charges can be offset against the interest income.

Impact

The effect of this exclusion allows personal insurance to be partly purchased with tax-free interest income. Although the interest earned is not currently paid to the policyholder, he may receive the interest payments if he terminates the policy. In the case of a surrender, the deferral of tax on this income is equivalent to an interest-free loan. Furthermore, there is usually no taxable income at death or on other payment of the proceeds, and thus the interest income is usually exempt from tax.

This provision thus offers preferential treatment for the purchase of life insurance coverage and for savings held in life insurance policies. Because middle income taxpayers are the major purchasers of this insurance, they are the primary beneficiaries of the provision. Higher income taxpayers who are not seeking insurance protection can obtain comparable, if not better, yields from tax-exempt State and local obligations.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	13. 6
10 to 20	22. 5
20 to 30	18. 4
30 to 50	17. 5
50 and over	28. 0

Rationale

The exclusion of death benefits dates back to the 1913 tax law. While no specific reason was given for exempting such benefits, insurance proceeds may have been excluded because they were believed to be comparable to bequests which also were excluded from the tax base.

The nontaxable status of the interest as it accumulates is based upon the general tax principle of "constructive receipt," i.e., that income is taxable to a cash basis taxpayer only when it is received by, or readily available to, him. The interest income is not viewed as readily available to the policyholder because he must give up the insurance protection by surrendering the policy in order to obtain the interest.

Further Comment

Although significant practical, social, and legal questions would be involved, the interest component could be taxed as earned or could be taxed when the proceeds are paid. Taxing the interest element when the proceeds are paid would still defer tax for the period from when it is earned until the time the proceeds are paid.

Selected Bibliography

Goode, Richard. "Policyholders' Interest Income from Life Insurance Under the Income Tax," *Vanderbilt Law Review*, December 1962, pp. 33–55.

———. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 125–33.

McLure, Charles E. "The Income Tax Treatment of Interest Earned on Savings in Life Insurance," in U.S. Congress, Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, pp. 370–405.

Vickrey, William S. *Agenda for Progressive Taxation*, Ronald Press, New York, 1947 (reprinted by Kelley, Clifton, N.J., 1970), pp. 64–75.

———. "Insurance Under the Federal Income Tax," *Yale Law Journal*, June 1943, pp. 554–85.

EXCLUSION OF CAPITAL GAINS ON HOME SALES FOR PERSONS AGE 65 OR OVER

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	70	------	70
1979	70	------	70
1978	70	------	70

Authorization

Section 121.

Description

An individual who is at least 65 years of age may exclude from taxable income part or all of the gain realized from selling the house used as his principal residence for at least 5 years of the 8-year period ending on the date of sale. If the home is sold for $35,000 or less, the entire gain may be excluded. If the home is sold for more than $35,000, only a part of the gain—calculated by multiplying the gain by the ratio of $35,000 to the sales price—is not taxed. This provision can only be used by a taxpayer once during a lifetime.

Example

A residence that cost $40,000 is sold for $70,000. The $30,000 gain is multiplied by $35,000/$70,000, so $15,000 is excluded from tax. Similarly, if the same residence were sold for $105,000, one-third ($35,000/$105,000) of the $65,000 gain, or $21,667, would be excluded.

Impact

This provision benefits elderly persons who sell their homes and do not purchase replacement homes. The benefits of this provision are more concentrated among higher income taxpayers than are some other provisions benefitting the aged (such as social security and the tax credit for the elderly). Other things being equal, there is an incentive for a homeowner to wait until age 65 before selling the house. Viewed in conjunction with section 1034 (which permits deferral of tax on gain realized upon the sale of a residence when a residence of the same or greater cost is purchased within 18 months), section 121 allows a permanent exemption of some or all of the gain realized on prior home sales which met the requirements of section 1034.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	2.5
10 to 20	15.0
20 to 30	17.5
30 to 50	15.0
50 and over	50.0

Rationale

This provision was initially enacted in 1964 to provide relief for elderly taxpayers who sell their houses to rent apartments or make other living arrangements. The committee report noted that section 1034 (see p. 87) often did not help the elderly who desired to purchase a smaller house or rent an apartment.

Initially, the entire gain could be excluded only if the sale price was no more than $20,000, and only a part could be excluded if the house sold for more. The Tax Reform Act of 1976 raised this figure to $35,000 to adjust for the substantial increase in the median sales price of single family homes since the provision had been originally enacted.

Further Comment

In August 1978, the House voted to repeal the existing treatment of gain realized on the sale of a principal residence by a taxpayer 65 or over. Instead, the House provided that an individual, regardless of age, can elect to exclude from gross income up to $100,000 ($50,000 in the case of married persons who file separate returns) of any gain realized on the sale of his principal residence. The exclusion would apply only once in a taxpayer's lifetime.

Selected Bibliography

U.S. Congress. House. Committee on Ways and Means. *General Tax Reform*, Panel Discussions, Part 2—Capital Gains and Losses (note, particularly, statement of Kenneth B. Sanden, p. 254).

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 428–29.

ADDITIONAL EXEMPTION FOR THE ELDERLY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	1, 275	------	1, 275
1979	1, 215	------	1, 215
1978	1, 155	------	1, 155

Authorization

Section 151(c).

Description

An additional personal exemption of $750 is allowed for a taxpayer who is 65 or older.

In addition, for taxable year 1978, taxpayers 65 or over are entitled to treat the special exemption for the elderly as a personal exemption in calculating the general tax credit. Under the general tax credit provisions, an individual is permitted to take a tax credit equal to the greater of (1) 2 percent of the first $9,000 of taxable income, or (2) $35 for each personal and dependency exemption.

Impact

The amount of tax relief per exemption increases from $105 to $525 as the marginal tax rate increases from 14 to 70 percent, and from $140 to $560 assuming a general tax credit of $35. This provision offers no assistance to elderly persons who have no tax liability.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	32. 8
10 to 20	30. 9
20 to 30	13. 2
30 to 50	11. 1
50 and over	11. 9

Rationale

The additional personal exemption originally was provided in the Revenue Act of 1948 to provide tax relief for the elderly whose income sources were reduced by old age. In 1977, the general tax credit was extended to the extra exemption for the elderly in order to incorporate the general tax credit into the tax tables.

Further Comment

The present additional exemption should be viewed within the context of the total transfer payment program currently in force, parts of which only provide cash payments to needy elderly persons. See the comment under the exclusion for social security benefits, page 138.

Selected Bibliography

Groves, Harold M. *Federal Tax Treatment of the Family*, The Brookings Institution, Washington, D.C., 1963, pp. 52–53.

ADDITIONAL EXEMPTION FOR THE BLIND

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	20	------	20
1979	20	------	20
1978	20	------	20

Authorization

Section 151(d).

Description

Blind taxpayers receive a special exemption of $750 in addition to the normal personal exemption. The extra exemption is not available for blind dependents.

In addition, for taxable year 1978, blind taxpayers are entitled to treat the special exemption for blindness as a personal exemption for calculating the general tax credit. Under the general tax credit provisions, an individual is permitted to take a tax credit equal to the greater of (1) 2 percent of the first $9,000 of taxable income, or (2) $35 for each personal and dependency exemption.

Impact

The benefits accrue to taxpayers who are blind or have a blind spouse. Because of their disability, blind persons may incur extra expenses to live at a given standard, and the extra exemption helps compensate for this. The amount of tax relief per exemption increases from $105 to $525 as the marginal tax rate increases from 14 to 70 percent, and from $140 to $560 assuming a general tax credit of $35.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	30.0
10 to 20	30.0
20 to 30	15.0
30 to 50	10.0
50 and over	15.0

Rationale

Special tax treatment for the blind first appeared in 1943 when additional benefits were available through an itemized deduction. The law was amended in 1948 to offer relief as an exemption so that all blind taxpayers could claim the allowance. In 1977, the general tax credit was extended to the extra exemption for the blind in order to incorporate the general tax credit into the tax tables.

Selected Bibliography

Groves, Harold M. *Federal Tax Treatment of the Family*, The Brookings Institution, Washington, D.C., 1963, pp. 54–55.

DEDUCTIBILITY OF CASUALTY LOSSES

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	430	------	430
1979	395	------	395
1978	360	------	360

Authorization

Section 165(c)(3).

Description

To the extent it exceeds $100, the uninsured portion of losses attributable to theft, fire, storm, shipwreck, or other casualty, may be deducted from adjusted gross income.

Impact

This provision grants some financial assistance to those who suffer casualties, have tax liability, and itemize deductions. It shifts part of the loss from the property owner to the general taxpayer, and thus serves as a form of insurance. The same dollar amount of loss has a proportionately greater effect on a low-income family than on a higher income family, yet the insurance feature of the deduction is greater for taxpayers in higher income tax brackets.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	4. 4
10 to 20	28. 7
20 to 30	19. 1
30 to 50	23. 7
50 and over	24. 1

Rationale

The deduction for casualty losses was allowed under the original 1913 income tax law without distinction between business-related and nonbusiness-related losses. No rationale was offered then. In 1964, the $100 floor on the deduction was enacted, and the purpose of relieving hardship was articulated in the legislative history.

30-560—78——12

Further Comment

Several proposals to limit the casualty loss deduction have been made. The most common proposal would permit a deduction for only as much of the loss as exceeds 3 percent of adjusted gross income. Proposals of this nature have been made at various times by the Treasury Department, members of the Ways and Means Committee, and others. This approach would continue relief for very large losses in relation to income, but would remove the deduction for relatively smaller losses.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 153–55.

Kahn, C. Harry. *Personal Deductions in the Federal Income Tax*, Princeton University Press for the National Bureau of Economic Research, Princeton, N.J., 1960, pp. 1–6 and 156–61.

TAX CREDIT FOR THE ELDERLY

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	255	------	255
1979	255	------	255
1978	250	------	250

Authorization

Section 37.

Description

Individuals who are 65 or more years old are allowed a tax credit nominally equal to 15 percent of up to $2,500 of taxable income for a single person or on a joint return where only one spouse is 65 or more, or up to $3,750 of taxable income on a joint return where both spouses are 65 or more. The limits of $2,500 and $3,750 are reduced (1) by tax exempt retirement income such as social security benefits, and (2) by one-half of the taxpayer's adjusted gross income over $7,500 for single individuals and over $10,000 for a married couple filing a joint return.

A 15-percent credit is also applicable to the retirement income of individuals under 65 years of age receiving pensions under a public retirement system, and can be elected by married couples where one spouse is under 65. However, qualifying retirement income under this computation is reduced by an earned income phaseout. Thus, if an individual is under 62, the maximum base must be reduced by earned income in excess of $900. If an individual is 62 or over but under 72, the maximum base must be reduced by 50 percent of earned income in excess of $1,200 and under $1,700, and by all earnings over $1,700. This credit is not subject to the adjusted gross income phase-out, however.

Example

A husband and wife are both 66 and file a joint return. He receives a taxable pension of $5,000, wages of $3,000, and a social security pension of $1,000. She receives a taxable pension of $2,000, wages of $1,000, and a social security pension of $400. They receive interest income of $200 on savings. The tax credit for the elderly is computed as follows:

Maximum amount upon which credit may be based		$3,750.00
Less:		
Husband's social security pension	$1,000.00	
Wife's social security pension	400.00	
One-half of adjusted gross income in excess of $10,000 (½ of $1,200)	600.00	
Total	2,000.00	
Amount on which tax credit is based		1,750.00
Amount of credit (15% of $1,750)		232.50

Impact

The maximum credit per individual is $375 (15 percent of $2,500), and $552.50 in the case of a married couple both 65 or over (15 percent of $3,750). Because the amount of eligible income is reduced by the amount of social security benefits received, the primary beneficiaries of this provision are Federal retirees and those State and local government retirees who do not receive social security benefits.

The adjusted gross income phaseout limits the tax relief largely to low- and middle-income taxpayers. In conjunction with the standard deduction and the additional personal exemption for persons 65 or older, the provision permits low-income elderly persons who work to receive substantial amounts of income before becoming taxable. Since public retirees under age 65 are not subject to the adjusted gross income phaseout, they have an advantage over retirees age 65 and over, if income in both cases is solely from pensions.

Because the provision is a credit, its value to a taxpayer is affected only by the level of benefits and not by the tax bracket of the recipient. Nevertheless, the benefits from the credit are slightly less concentrated in the lower range of the income scale than the tax relief from the exclusion of social security benefits.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	65.2
10 to 20	30.0
20 to 30	4.3
30 to 50	0.4
50 and over	0

Rationale

The tax credit for the elderly enacted in 1976 revised and restructured the retirement income credit. The retirement income credit, originally enacted in 1954, was intended to remove inequities between individuals who receive retirement income that was not tax exempt and recipients of social security, which is tax exempt. At that time, many features of the credit were closely related to the social security benefit system. The retirement income credit was applicable to retirement income only. No revision had been made in the maximum amount eligible for the credit between 1962 and 1976, even though social security benefits had increased substantially during that period.

The tax credit for the elderly was enacted in order to: (1) update the maximum amount of income eligible for the credit; (2) eliminate the complexity of the retirement income credit which had resulted from patterning it after the social security law; and (3) eliminate the discrimination among individuals depending on their source of income. For example, elderly taxpayers who had to support themselves by earning income because they had no retirement income now could qualify for the credit, but had previously been ineligible.

Selected Bibliography

U.S. Congress. House. Committee on Ways and Means. *Retirement Income Credit, Child Care Deduction, Qualified Stock Options, and Sick Pay Exclusion*, Committee Print, Sept. 22, 1975, pp. 1–4.

U.S. Congress. Joint Committee on Taxation. *General Explanation of the Tax Reform Act of 1976*, Dec. 29, 1976, pp. 117–23.

EARNED INCOME CREDIT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals		Corporations	Total
	Refundable	Nonrefundable [1]		
1980	------	------	------	------
1979	900	265	------	1,165
1978	945	285	------	1,230

[1] Only earned income credits that reduce tax liability are tax expenditures. Payments in excess of the recipients' tax liability (knowu as "refundable" payments) are now treated as direct spending budget authority and outlays, rather than as tax expenditures. However, the refundable payments are included in this table to indicate the overall impact of the credit.

Authorization

Section 43.

Description

This tax credit is available only to low-income workers who maintain a household for one or more of their dependent children who are either under age 19, students, or disabled. The maximum credit is 10 percent of the first $4,000 of earned income. The credit is reduced by 10 percent of the taxpayer's adjusted gross income (AGI) (or earned income if greater) above $4,000, so that it becomes zero at AGI of $8,000.

The credit is subtracted from tax liability, if any. As contrasted with all previously enacted tax credits, credits in excess of tax liability are paid in cash to the eligible worker. Amounts refunded to an individual under the earned income credit provisions are not considered income for determining eligibility under Federal assistance programs.

The provision is scheduled to expire December 31, 1978.

Impact

The earned income credit may be viewed as a partial offset to social security taxes on low-income workers. The combined employer-employee social security tax rate is 12.1 percent (6.05 percent paid by each party). Assuming the employee bears the burden of the employer's portion in the form of lower wages, the 10-percent credit offsets nearly 85 percent of the tax.

The credit may help to encourage low-income workers to obtain employment and, thus, reduce the demand for welfare and unemployment benefits. However, many of those most in need of relief may fail to file the tax return necessary to claim the credit.

Because of the phaseout of eligibility for the credit between $4,000–$8,000 of income, all the benefits of the credit are received by persons in the lowest expanded gross income category, $0–$10,000.

Rationale

The earned income credit was first enacted in the Tax Reduction Act of 1975. Providing relief from social security taxes for low-income workers was one purpose. Another reason cited by the tax writing committees was to provide relief to low-income people for recent increases in food and fuel prices. Some opponents believe relief of this nature would be more efficiently administered as a reduction of social security tax payments made by low-income wage earners.

The credit was continued by the Revenue and Adjustment Act of 1975, extended and broadened by the Tax Reform Act of 1976, and extended through 1978 by the Tax Reduction and Simplification Act of 1977.

Further Comment

The House voted in August 1978 to make the earned income credit permanent, and also agreed to a number of amendments to simplify the calculation of the credit.

Selected Bibliography

Brittain, John A. "Social Security Taxes: Problems and Prospects for Reform Revisited," *Tax Notes*, Feb. 8, 1976, pp. 18–25.

U.S. Congress. House. *Tax Reform Act of 1976*, H. Rept. No. 94–1515, 94th Cong., 2d sess., Sept. 13, 1976, pp. 429–30.

U.S. Congress. Senate. *Tax Reduction Act of 1975*, S. Rept. No. 94–136, 94th Cong., 1st sess., Mar. 17, 1975, pp. 11, 32–35.

VETERANS BENEFITS AND SERVICES

(1) Exclusion of Veterans Disability Compensation
(2) Exclusion of Veterans Pensions
(3) Exclusion of GI Bill Benefits

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals			Corporations	Total
	Veterans disability compensation	Veterans pensions	GI bill benefits		
1980	855	40	150	------	1,045
1979	830	40	170	------	1,040
1978	840	40	200	------	1,080

Authorization

38 U.S.C. 3101.

Description

All benefits administered by the Veterans Administration are exempt from income tax. These include veterans disability compensation, veterans pension payments, and education payments.

Impact

Veterans service-connected disability compensation payments are related not to income levels, but to the average impairment of earnings capacity in civil occupations resulting from the various injuries.

The pensions paid to qualifying nonservice-disabled and aged veterans are based on "countable" income. Reaching age 65 or older is considered a *de facto* disability. The larger a veterans' countable income is, the smaller his pension will be. Countable income excludes various items, the most significant of which is the earnings of a spouse. Therefore, veterans with the same pension—based on the same countable income—can have quite different amounts of total income when the excluded items are taken into account.

Veterans education benefits vary with the number of dependents and type of training.

Based upon the foregoing criteria, beneficiaries of all three major veterans programs to varying degrees may have amounts of taxable income in addition to their tax exempt veterans benefits. Thus, the value of tax exemption of these veterans benefits increases with the marginal tax bracket of the recipients.

Estimated Distributions of Individual Income Tax Expenditures by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	Percentage distributions		
	Veterans disability compensation	Veterans pensions	GI bill benefits
0 to 10	17. 3	85. 7	63. 5
10 to 20	43. 2	14. 3	28. 5
20 to 30	26. 3	0	5. 8
30 to 50	9. 8	0	1. 5
50 and over	3. 4	0	0. 8

Rationale

Since 1917, veterans benefits have been exempt from income tax. The original rationale for the exemption is not clear.

Further Comment

One general issue concerning these benefit programs which has been the subject of discussion is whether net (after-tax) benefit differentials should depend on the tax bracket of the recipient. Increases in the amount of direct payments under the programs are alternatives to the current exemptions.

Selected Bibliography

Goode, Richard. *The Individual Income Tax*, Rev. ed., The Brookings Institution, Washington, D.C., 1976, pp. 100–03.

CREDITS AND DEDUCTIONS FOR POLITICAL CONTRIBUTIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	60	------	60
1979	75	------	75
1978	60	------	60

Authorization

Sections 41 and 218.

Description

Individual, but not corporate, taxpayers are allowed a tax credit equal to one-half of their political contributions to candidates for Federal, State, or local office and to national political parties. The credit cannot exceed $25 for a single individual or $50 for a married couple.

In lieu of the credit, an individual taxpayer may elect to take an itemized deduction not to exceed $100 for a single person or $200 for a married couple.

Impact

The credit allows a taxpayer to reduce the cost of a limited amount of political contributions by 50 percent, i.e., for each $2 of contribution—up to the limit of $50 per taxpayer—the Federal Government returns a dollar to the taxpayer, in effect matching the taxpayer's contribution. The deduction option is preferable for taxpayers whose income is above the 50-percent bracket. For example, at the maximum rate of 70 percent, the taxpayer's net cost of the first $100 of contributions is $30; i.e., the Government matches the $30 contribution with a $70 contribution. Because of the dollar limitations, this provision is obviously not of great significance to large contributors.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	15.3
10 to 20	31.8
20 to 30	22.4
30 to 50	15.3
50 and over	15.3

Rationale

The credit and deduction for political contributions were adopted with half the current limits as part of the Revenue Act of 1971 and the maximum amounts were increased in 1974. Their purpose was to encourage more widespread financing of political campaigns through small contributions.

Further Comment

The House voted in August 1978 to repeal the deduction for political contributions, and to leave this tax expenditure only in the form of a tax credit.

Selected Bibliography

U.S. Congress. Joint Committee on Internal Revenue Taxation. *General Explanation of the Revenue Act of 1971*, Dec. 15, 1972.

EXCLUSION OF INTEREST ON GENERAL PURPOSE STATE AND LOCAL DEBT

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	2, 390	4, 305	6, 695
1979	2, 150	3, 865	6, 015
1978	1, 925	3, 470	5, 395

Authorization

Section 103.

Description

In general, interest on the obligations of State and local governments is excludable from gross income.[1]

Impact

Because the interest is exempt from tax, the interest rate on State and local government obligations is lower than the rate on comparable taxable bonds. In effect, the Federal Government subsidizes States and localities by paying part of their interest cost. For example, if the market rate on tax-exempt bonds is 7 percent when the taxable rate is 10 percent, there is a 3 percentage point subsidy to State and local governments.

Tax-exempt bonds are viewed by some persons as a particularly attractive form of indirect Federal aid because they operate automatically without Federal regulation.

Commercial banks and high-income individuals are the major buyers of tax-exempt bonds. Of the estimated $248.7 billion in outstanding municipal debt in 1976 (more than 2½ times the $93 billion outstanding in 1964), about 43 percent was held by commerical banks and 32 percent by individuals. One study indicated that the tax exemption reduced the tax rate of commercial banks by an average of 19 percentage points. Another study estimated that the average marginal tax rate for individual investors in tax-exempts is approximately 55 percent.

Tax-exempt institutions, such as pension funds, have no incentive to invest in tax-free bonds since the return is much lower than that of taxable securities. Therefore, the tax-exempt nature of State and local debt, in effect, restricts the potential market for these securities to taxable individuals and organizations.

[1] For a description of State and local government pollution control and industrial development bonds, see pp. 39–41 and 61–63, respectively. The discussion of general purpose State and local obligations excludes consideration of these special purpose obligations.

Commercial banks generally do not consider tax-exempt bonds as priority investments, and leave the tax-exempt market when money is tight. Rising interest rates increase the profitability of bank loans relative to that of investments in municipal obligations, causing the banks to substitute the former for the latter in their portfolios. The Federal Reserve Board has estimated in three separate studies that a one-tenth rise in the rate of interest results in a 4- to 6-percent drop in tax-exempt bond sales.

This tax expenditure subsidizes interest on debt that generally finances capital expenditures such as buildings. Thus, such projects are encouraged compared to other municipal expenditures not financed by debt such as operating expenses.

The tax-exempt bond provision is estimated to cost the Treasury approximately $1.00 to deliver 75 cents in aid to State and local governments through this means. It is estimated that in fiscal year 1977, $4.8 billion in Federal revenue was foregone to save State and local governments about $3.6 billion in interest costs. The estimated difference of $1.2 billion was tax relief to investors.

This difference between foregone revenue and interest cost reduction results from the fact that the tax exemption provides additional tax savings to high income taxpayers with marginal tax brackets above the minimum level of those taxpayers the issuer is attempting to attract to its bonds. To see why this is so, consider the following hypothetical example. State X wants to sell $200,000 worth of general obligation bonds. Suppose the interest rate for taxable corporate bonds is 10 percent. Suppose further that two potential investors, A and B, each with $100,000 to invest, are considering purchasing the bonds. A is in the 50 percent marginal income tax bracket; B is in the 20 percent marginal income tax bracket. If the interest on the bonds were not tax exempt, State X would have to pay A and B $10,000 each to forego corporate bonds and invest in its bonds. In after-tax terms, the $10,000 would be worth $5,000 to A and $8,000 to B. Since the bonds are tax exempt, State X need pay only $8,000 to B to induce him to invest. It also must pay $8,000 to A. Total interest savings to State X as a result of the tax exemption is therefore $4,000. A's tax savings are 50 percent of his $8,000 of interest, or $4,000. Total tax savings to B are 20 percent of his $8,000 of interest, or $1,600. Total Federal revenue foregone would therefore be $5,600. Interest cost reductions as a percentage of foregone revenue in this example would be $4,000/$5,600, or 71 percent.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class [1]

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	0. 1
10 to 20	2. 5
20 to 30	3. 4
30 to 50	8. 7
50 and over	85. 3

[1] The distribution refers to the individual tax expenditure only. The corporate tax expenditure resulting from this tax provision is not reflected in this distribution table.

Rationale

This exemption has been in the income tax law since 1913, and apparently was based on the belief that the Federal Government could not constitutionally tax such interest. Today, the exemption is justified on other grounds, principally as a means of assisting State and local governments with a minimum of Federal interference.

Further Comment

Two options are frequently mentioned as alternatives or supplements to the exclusion. The first would give States and localities the choice of issuing either taxable or tax-exempt bonds. A Federal subsidy then would be provided to those issuing taxable bonds to compensate them for the higher interest cost that would be incurred. Proponents of this option argue that it would stabilize and expand the municipal bond market and enhance the cost-effectiveness of the subsidy. Others believe that the proposal could result in the eventual diminution of fiscal autonomy of municipal authorities, and would render the subsidy more visible. Some also fear that a subsidized taxable bond market would destroy the tax-exempt market to which State and local governments already are accustomed.

The second option would create a federally financed development bank that would raise funds by selling taxable bonds at market rates, and then lend to States and localities at lower interest rates.

Under most initial projections, both options would result in substantial increases in absolute long-term net outlays by the Federal Government because the direct subsidy payments are expected to exceed the increased income taxes paid by the recipients of the taxable securities.

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DEDUCTIBILITY OF NONBUSINESS STATE AND LOCAL TAXES (Other Than on Owner-Occupied Homes and Gasoline)

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	10, 480	------	10, 480
1979	9, 440	------	9, 440
1978	8, 505	------	8, 505

Authorization

Section 164.

Description

An individual can claim certain State and municipal sales, income, and personal property tax payments as itemized deductions.

Impact

This deduction for State and local tax payments benefits only taxpayers who itemize their deductions. They are concentrated in the middle and higher income brackets, largely among persons who own homes, because these are the taxpayers who generally itemize.

The Federal tax deduction for State and local sales taxes and miscellaneous taxes accentuates the generally regressive nature of these taxes because the amount of tax benefit per dollar of deduction increases with the tax bracket of the taxpayer. State and local income taxes generally are progressive, but the Federal deduction lessens the effect of their progressivity.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	1. 1
10 to 20	14. 0
20 to 30	22. 3
30 to 50	23. 4
50 and over	39. 2

Rationale

The allowance of a deduction for taxes in general has always been a part of the income tax structure including the Civil War income tax. Although the legislative history is not explicit, it suggests that

30-560—78——13

taxes were viewed as reducing net income. Some now regard this treatment as a form of revenue sharing. As with many other deductions, no distinction was made between business and nonbusiness taxes. The deduction for the Federal income tax was eliminated in 1917 and, for Federal excise taxes, in 1943. The deduction for State and local taxes on tobacco and alcoholic beverages was eliminated in 1964, along with automobile and drivers' licenses and other State and local selective excise taxes except gasoline taxes.

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TAX CREDIT FOR CORPORATIONS DOING BUSINESS IN PUERTO RICO AND U.S. POSSESSIONS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	------	565	565
1979	------	520	520
1978	------	485	485

Authorization

Section 936.

Description

A qualifying domestic corporation may elect not to pay tax on income earned in U.S. possessions except the Virgin Islands. A corporation qualifies if, for the 3-year period preceding the end of the tax year, at least 80 percent of its gross income has been from sources within a possession, and at least 50 percent of its gross income is from the active conduct of a trade or business within a possession. This exemption is accomplished by granting a credit equal to the tax which otherwise would be paid on income earned within a possession. Full deductions are provided for dividends received by parent corporations from subsidiaries that elect the possessions credit.

The credit can apply to corporations conducting business in the Commonwealth of Puerto Rico and all possessions of the United States (mainly Guam, the Canal Zone, and Wake Island) except the Virgin Islands.

Impact

Corporations operating in Puerto Rico account for 99 percent of the estimated revenue loss from this tax expenditure.

Puerto Rico grants substantial tax holidays (i.e., multiyear tax-free periods) to encourage corporations to engage in manufacturing operations in the Commonwealth. Most "possessions corporations" are subsidiaries of U.S. corporations with U.S. (and sometimes foreign) operations. The combination of the possessions credit and Puerto Rican tax holidays results in no income tax being paid to any taxing authority. Puerto Rico has claimed that granting these incentives to U.S. firms is a vital part of the continued growth and development of the Puerto Rican economy.

A recent Treasury Department report concludes that the earlier agreed upon estimates provided above underestimated the revenue losses from this provision. The new Treasury estimates are $774

million, $703 million, and $687 million for FY 1980, FY 1979, and FY 1978, respectively.

No data is available on the use of the new credit, which only went into effect in 1976. However, the Treasury report indicates that in 1975, under the prior exclusion rule which was replaced by the credit, the Federal tax expenditure per Puerto Rican employee averaged $7,428 in all manufacturing industries. This was slightly higher than the average compensation of possessions corporations' employees, which was $7,300. For pharmaceutical companies the tax expenditure represented almost $35,000 per employee, while for traditional labor intensive industries the tax expenditure averaged less than $3,000 per employee.

The Treasury estimates that in 1975 almost 49 percent of the tax expenditure benefits from the possessions corporation exclusion went to pharmaceutical companies. Other types of businesses making substantial use of the exclusion were electrical and electronic equipment manufacturers.

The Treasury also estimates that 30 companies received 80 percent of the total benefits derived from the possessions corporation rules in 1975.

Rationale

An exclusion for income earned in possessions was enacted in 1921. Floor debate indicated it was intended to encourage export trade (especially to South America) by improving the competitive position of U.S. companies in foreign markets. The exclusion was converted to a credit by the Tax Reform Act of 1976. One reason for this conversion was that the exclusion discouraged the possessions corporation from paying dividends, but rather encouraged parent firms to liquidate their possessions corporations at the end of tax holidays. The 1976 legislation also eliminated an incentive under the prior law for possessions corporations to invest their earnings outside both Puerto Rico and the United States. The credit is now justified as necessary to assist the economic growth of Puerto Rico.

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DEFERRAL OF INCOME ON SAVINGS BONDS

Estimated Revenue Loss

[In millions of dollars]

Fiscal year	Individuals	Corporations	Total
1980	725	------	725
1979	670	------	670
1978	625	------	625

Authorization

Section 454.

Description

Where Federal Government noninterest bearing obligations, such as Series E savings bonds, are issued at a discount and redeemable for fixed amounts increasing at stated intervals, the increase in the redemption price is, at the option of the holder, not subject to income tax until the bond is redeemed (which may extend past the original maturity date). In addition, Series E bonds can be exchanged for Series H bonds, which pay interest, without including in income the income previously earned on the Series E bonds. This income becomes subject to tax only when the Series H bonds are redeemed. The tax-free conversion is not available to corporations or to any individual taxpayer on the accrual basis.

Impact

The deferral of income resulting from owning savings bonds provides two advantages. First, payment of tax on the income is deferred, amounting to an interest-free loan. Second, if bonds are purchased for retirement purposes, the taxpayer often is in a lower income bracket when the bonds are redeemed.

There has been virtually no analysis of the impact of this provision. If the provision were removed, an increase in the interest rate might be necessary to sell the same amount of bonds. However, the effect of this provision on the demand for savings bonds may be minimal since other factors may be much more significant. These include habit, convenience of a payroll deduction plan, security, patriotism, and the exemption for such income from State and local income taxes.

Estimated Distribution of Individual Income Tax Expenditure by Expanded Gross Income Class

Expanded gross income class (thousands of dollars):	*Percentage distribution*
0 to 10	14. 2
10 to 20	22. 4
20 to 30	18. 3
30 to 50	17. 3
50 and over	27. 9

Rationale

Prior to 1951, a cash-basis taxpayer generally reported income on U.S. Treasury original issue discount bonds in the year of redemption or maturity, whichever came first. In 1951, when provision was made to extend Series E bonds past their dates of original maturity, a provision was enacted to allow the taxpayer either to report the interest currently, or at the date of redemption, or upon final maturity. The committee reports indicated that the provision was adopted to facilitate the extension of maturity dates.

In 1959 a provision was added to allow taxpayers to convert Series E bonds to Series H bonds without paying tax on the accrued interest. The purpose was to encourage the holding of U.S. bonds.

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Appendix A

FORMS OF TAX EXPENDITURES

Exclusions, Exemptions, Deductions, Credits, Preferential Rates, and Deferrals

Tax expenditures may take any of the following forms: (1) special exclusions, exemptions, and deductions, which reduce taxable income and, thus, result in a lesser amount of tax; (2) preferential tax rates, which reduce taxes by applying lower rates to part or all of a taxpayer's income; (3) special credits, which are subtracted from taxes as ordinarily computed; and (4) deferrals of tax, which result from delayed recognition of income or from allowing in the current year deductions that are properly attributable to a future year.

Computing Tax Liabilities

A brief explanation of how tax liability is computed will help illustrate the relationship between the form of a tax expenditure and the amount of tax relief it provides.

CORPORATE INCOME TAX

Corporations compute taxable income by determining gross income (net of any exclusions) and subtracting any deductions (essentially costs of doing business). Although the first $25,000 of corporate taxable income is taxed at 20 percent and the next $25,000 is taxed at 22 percent,[1] the corporation income tax is essentially a flat rate tax at 48 percent of taxable income in excess of $50,000. Any credits are deducted from tax liability calculated in this way. The essentially flat statutory rate of the corporation income tax means there is very little difference in marginal tax rates to cause variation in the amount of tax relief provided by a given tax expenditure to different corporate taxpayers. However, corporations without current tax liability will benefit from tax expenditures only if they can carry back or carry forward a net operating loss or credit.

INDIVIDUAL INCOME TAX

Individual taxpayers compute gross income which is the total of all income items except exclusions. They then subtract certain deductions (deductions from gross income or "business" deductions) to arrive at adjusted gross income. The taxpayer then has the option of "itemizing" personal deductions or taking the standard deduction. The taxpayer then deducts personal exemptions to arrive at taxable income. A graduated tax rate structure is applied to this taxable income to yield tax liability, and any credits are subtracted to arrive at the net after-tax liability.

[1] This rate will expire on December 31, 1978, unless extended. The rates will then revert to 22 percent on the first $25,000 and 48 percent on the excess.

Exclusions, Deductions, and Exemptions

The amount of tax relief per dollar of each exclusion, exemption, and deduction increases with the taxpayer's marginal tax rate. Thus, the exclusion of interest from State and local bonds saves $50 in tax for every $100 of interest for the taxpayer in the 50-percent bracket, whereas for the taxpayer in the 25-percent bracket the saving is only $25. Similarly, the extra exemption for persons over age 65 and any itemized deduction is worth twice as much in tax saving to a taxpayer in the 50-percent bracket as to one in the 25-percent bracket.

In general, the following deductions are itemized, i.e., allowed only if the standard deduction is not taken: medical expenses, specified State and local taxes, interest on nonbusiness debt such as home mortgage payments, casualty losses, certain unreimbursed business expenses of employees, charitable contributions, expenses of investment income, union dues, costs of tax return preparation, uniform costs, and political contributions. Whether or not a taxpayer minimizes his tax by itemizing deductions depends on whether the sum of those deductions exceeds the limits on the standard deduction. Higher income individuals are more likely to itemize because they are more likely to have larger amounts of itemized deductions which exceed the standard deduction allowance. Homeowners generally itemize because deductibility of mortgage interest and property taxes generally leads to larger deductions than the standard deduction.

Preferential Rates

The amount of tax reduction that results from a preferential tax rate (such as the 50-percent maximum tax rate on earned income) depends on the difference between the preferential rate and the taxpayer's ordinary marginal tax rate. The higher the marginal rate that would otherwise apply, the greater is the tax relief from the preferential rate.

Credits

A tax credit (such as the investment credit) is subtracted directly from the tax liability that would accrue otherwise; thus, the amount of tax reduction is the amount of the credit and is not contingent upon the marginal tax rate. A credit can (with one exception) only be used to reduce tax liabilities to the extent a taxpayer has sufficient tax liability to absorb the credit. Most tax credits can be carried backward and/or forward for fixed periods, so that a credit which cannot be used in the year in which it first applies can be used to offset tax liabilities in other prescribed years.

The earned income credit is the only tax credit which is now refundable. That is, a qualifying individual will obtain in cash the amount of the refundable credit in excess of his tax liability when he files his tax return for the year in which the credit applies.

Deferrals

Deferral can result either from postponing the time when income is recognized for tax purposes or from accelerating the deduction of expenses. In the year in which a taxpayer does either of these, his taxable income is lower than it otherwise would be, and because of

the current reduction in his tax base, his current tax liability is reduced. The reduction in his tax base may be included in taxable income at some later date. However, the taxpayer's marginal tax rate in the later year may differ from the current year rate because either the tax structure or the applicable tax rate has changed. Furthermore, in some cases the current reduction in the taxpayer's tax base may never be included in his taxable income. Thus, deferral works to reduce current taxes, but there is no assurance that all or even any of the deferred tax will be repaid. On the other hand, the tax repayment may even exceed the amount deferred.

A deferral of taxes has the effect of an interest-free loan for the taxpayer. Apart from any difference between the amount of "principal" repaid and the amount borrowed (i.e., the tax deferred), the value of the interest-free loan—per dollar of tax deferral—depends on the interest rate at which the taxpayer would borrow and on the length of the period of deferral. If the deferred taxes are never paid, the deferral becomes an exemption. This can occur if, in succeeding years, additional temporary reductions in taxable income are allowed. Thus, in effect, the interest-rate loan is refinanced; the amount of refinancing depends on the rate at which the taxpayer's income and deductible expenses grow and can continue in perpetuity.[2]

TEMPORARY EXCLUSIONS

The Domestic International Sales Corporation (DISC) provision is an example of deferral through a temporary exclusion of income, with recognition of the income for tax purposes occurring subsequently. In some cases, the deferral may continue indefinitely and the effect is a permanent exclusion of taxable income.

ACCELERATED DEDUCTIONS

More commonly, deferrals occur through the acceleration in the deduction of expenses. Ordinarily, the cost of acquiring an income-producing asset which undergoes economic decline (such as a machine) is capitalized and deducted over the asset's useful life. The amount of deduction taken in each year depends on the useful life and the rate of depreciation applied. The shorter the useful life and the higher the rates applied, the more quickly deductions are taken. To reflect net income, the share of the asset cost used up in any one year should be deducted as an expense against income produced by the asset in that year. However, if a larger amount is deducted in earlier years, tax liability is lower than it otherwise would be. Just the reverse is true in later years when the deduction is lower and tax liability is higher than it otherwise would be, and thus a tax deferral occurs.

Rapid write-off methods which are considered tax expenditures include: (1) expensing 100 percent of capital costs as incurred, (2) using a shorter life (as in the asset depreciation range), (3) using a faster rate (as in accelerated depreciation on buildings), and (4) using various 5-year amortization provisions. The tax saving from various rapid write-off methods is illustrated by the following example.

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[2] The tax expenditures for deferrals are estimates of the difference between tax receipts under the current law and tax receipts if the provisions for deferral had never been in effect. Thus, the estimated revenue loss is greater than what would be obtained in the first year of transition from one tax law to another. The amounts are long-run estimates at the level of economic activity for the year in question.

Assume a $10,000 asset with an even rate of economic depreciation over a 10-year life is held by a taxpayer with a marginal tax rate of 50 percent. The appropriate deduction, in this case "straight-line," would be $1,000 each year, and the resulting annual tax reduction would be $500 (50 percent of $1,000).

Expensing capital acquisitions

If the asset is expensed, the entire amount ($10,000) is deductible in the first year, and the tax reduction is $5,000 (50 percent of $10,000). This tax reduction is $4,500 greater than the $500 amount resulting from the "straight-line" method (where 10 percent is written off in each year of the 10-year life). In the second and all following years, no deduction will be taken. Thus, the net effect of expensing the cost of the asset is a $4,500 loan from the Government which is paid back without interest over the next 9 years (as no depreciation is deducted).

Shorter than actual useful lives

The use of any life shorter than the "true" 10-year economic life (in this example) provides similar but smaller amounts of tax benefit. If an 8-year life is used instead of a 10-year life, the deduction allowed in each of the first 8 years is $1,250, and the net tax deferral each year is $125 ($1,250—$1,000×50 percent) which is ultimately repaid in the last 2 years of the asset's actual useful life when no deductions are taken.

Rapid rate depreciation

There are several rapid rate alternatives to the straight-line method. The use of a rapid rate simply allows larger deductions in the earlier years of the asset's useful life (but does not affect the period over which the asset is written off). For example, the declining balance method applies a larger than straight-line rate against the balance (i.e., the asset cost less the allowed depreciation) remaining each year. To illustrate with a $10,000 asset, double declining balance depreciation in the first year is 2×1/10×$10,000 or $2,000—twice the straight-line depreciation, for a net tax saving of $500 (50 percent of $1,000). In the next year, the deduction is 2×1/10×$8,000 or $1,600, for a net tax saving of $300. Although depreciation deductions will continue over the entire life of the asset, they will be larger at the beginning and smaller at the end of the period.

For certain types of machinery and equipment, the pattern of economic decline may be more closely approximated by a rapid depreciation method than by straight-line. Indeed, the use of an accelerated depreciation rate for machinery and equipment is not considered a tax expenditure; however, it is considered so for buildings.[3] When, in the latter periods under an accelerated depreciation plan, the allowed expense is less than the actual depreciation, the difference "repays" the loan afforded by the allowance of earlier depreciation in excess of actual.[4]

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[3] The explanation for this treatment is that the tax depreciation allowed for machinery and equipment is thought to be closer to actual depreciation than that allowed on buildings. See "The Tax Expenditure Budget: A Conceptual Analysis," *Annual Report of Secretary of the Treasury, FY 1968*, p. 33.

[4] The taxpayer has the option to switch to straight-line depreciation of the undepreciated balance and usually may find it beneficial to do so. However, this option does not change the basic result; it simply increases the amount of interest saving.

Five-year amortization

There are several provisions in the tax expenditure budget which allow 5-year amortization. Rapid amortization reduces the taxpayer's liability by calculating straight-line depreciation over an arbitrary period—5 years—which is shorter than the actual useful life of the asset. Rapid amortization is a substitute for other depreciation which would have been allowed. In the $10,000 example, 5-year amortization would yield deductions of $2,000 in each of 5 years. Double declining balance depreciation would yield $2,000 the first year, $1,600 the second year, and declining amounts thereafter. However, the full investment credit cannot be taken if rapid amortization is used; the taxpayer has the choice of rapid amortization and a reduced or no investment credit depending upon the specific amortization statute, or whatever depreciation is allowed plus the full investment tax credit. If a $10,000 asset is eligible for the investment tax credit, an additional $1,000 of tax savings would occur in the first year. Thus, the investment tax credit plus the regular depreciation is likely to be better than 5-year amortization for the taxpayer in this case.

For a given asset, rapid amortization provides more tax saving the longer is the asset's useful life and the higher is the interest rate and the taxpayer's marginal tax rate. In the case of assets eligible for the 10-percent investment tax credit, it is unlikely the 5-year amortization provisions without any investment credit will be a better option. Where the investment tax credit does not apply to capital assets (such as housing rehabilitation expenditures), the 5-year amortization provision results in more tax saving than rapid depreciation if the asset's useful life is long enough.

Appendix B

CAPITAL GAINS

In the income tax law, profit from the sale of most investment assets is referred to as capital gain and receives preferentially lower tax rates. For individuals this lower rate is about one-half the usual rate although capital gains may also be subject to the minimum tax on tax preferences. Corporate long-term capital gains are taxed either as ordinary income of the corporation or at an alternative rate of 30 percent, whichever produces a lower tax.

Broadly speaking, capital gain or loss is produced by the sale or exchange[1] of capital assets.[2] The sale produces "long-term" gain or loss if the property has been owned for more than 12 months. If not, it produces "short-term" gain or loss. While the expression "capital gains" technically includes both long- and short-term gains, it generally is used to mean only long-term gains. Only long-term gains receive the preferential treatment.

Stocks and bonds owned by casual investors usually are capital assets. Inventory owned by a retailer is not a capital asset. Between these extremes, whether property is a capital asset is less clear, and in specific cases, the definitional problem may be a very difficult matter. In general, however, the distinction is that investments are capital assets but items held for sale in a business are not.

Another kind of property that may produce long-term capital gain is property used in a business—generally real estate and depreciable property—if it is not held for the purpose of being sold to customers and is owned more than 12 months.[3] Gain on this kind of property is treated as long-term capital gain only if all of the gains for the year exceed all of the losses for the year. If so, the net gain is long-term capital gain.

The gain on a particular sale receives preferential treatment only if it survives a number of complex computations. First, losses on long-term assets are subtracted from gains on long-term assets. Only the net figure survives and is referred to as net long-term gain. Short-term losses which have not been used to eliminate short-term gains are then offset against this net long-term gain. After this offset, any excess is defined by the statute as "net section 1201 gain" but is generally called capital gain and is entitled to preferential treatment.

For individuals, the preference is that one-half of the gain may be deducted, and only the other one-half is subject to tax. If this calculation produces a tax on the first $50,000 of gains which exceeds 25 percent of such gains, the lower 25 percent rate is applied to the the first $50,000 of gains. For corporations, the preference results by limiting the tax to no more than 30 percent of the gain.

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[1] Capital gain treatment is conferred only if there is a "sale or exchange." Other dispositions, e.g., an abandonment, do not result in capital gain or loss but rather in ordinary gain or loss. This technicality is beyond the scope of this appendix.

[2] This gain or loss will be recognized and taken into income unless one of many nonrecognition provisions apply. Nonrecognition provisions are beyond the scope of this appendix.

[3] The holding period is longer for some assets, most notably cattle and horses.

The increase in value of capital assets is taxed as a capital gain only if the asset is sold. As a consequence, the gross gains on unsold assets accumulate in value without being reduced by any accured tax.

As described on page 89 of this compendium, all previously untaxed appreciation of capital assets will be taxed as a capital gain subject to adjustments when a donee sells property received as a gift from a living donor. However, only appreciation that occurred after December 31, 1976, will be taxed as a capital gain subject to adjustments when an asset is sold by an heir who received the property as the result of death.

Note: The following description is provided for the reader who wants a more detailed outline of the way capital gains and losses are treated:

First, the gain or loss must be determined on each transaction involving a capital asset. Then the following procedural rules govern the tax treatment of capital gains and losses:

(1) Long-term gains and losses are agregated.

(2) Short-term gains and losses are aggregated.

(3) (a) If the aggregations in steps 1 and 2 both result in gains, long-term gain is treated as stated in step 4(a) and short-term gain is treated as stated in step 4(c).

(b) If the aggregations in steps 1 and 2 both result in losses, long-term loss is treated as stated in step 4(b), and short-term loss is treated as stated in step 4(d).

(4) If one of the aggregations in steps 1 and 2 produce a loss and the other a gain, the gain and loss are then aggregated, and the following rules govern:

(a) If the net is long-term gain, one-half of it is deducted by an individual in calculating gross income. An individual may elect for the first $50,000 of such gain to be taxed at a 25 percent alternative rate. Corporate long-term capital gain is either taxed as other corporate income or at the alternative rate of 30 percent, whichever yields the lower tax.

(b) If the net is long-term loss, individuals may deduct one-half of it from other income but not in excess of $3,000 per year. Corporations may not deduct any such loss from other income. There is an unlimited carryover to future years for individuals but no carryback. Corporations generally may carryback for 3 years and carryforward for 5 years, to offset capital gain.

(c) If the net is short-term gain, the entire amount is subject to tax.

(d) If the net is short-term loss, individuals may deduct it against ordinary income but not to exceed $3,000 per year, subject to the previously stated rules on carryovers and carrybacks. Corporations may not deduct any such loss from other income, subject to the rules on carryovers and carrybacks.

PART II

Tax Expenditures and Major Spending Programs With Related Purposes

INTRODUCTION

Section 102(a) of the Congressional Budget Act imposes upon the Senate Budget Committee the duty to "devise methods of coordinating tax expenditures, policies, and programs with direct budget outlays." Part II of this compendium contains background information and analyses to assist the Budget Committee in fulfilling this statutory responsibility.

Part II of the compendium contains 17 sections, each comparing tax expenditures with related spending programs in a different budget policy area. Each section contains:

A brief summary of the tax expenditures to be discussed, and a reference to the relevant pages of Part I of this compendium where the tax expenditures are explained in greater detail;

An overview of the spending programs that are discussed and compared with the tax expenditures;

A comparative analysis of the tax expenditures and spending programs, with particular emphasis given to the goals of the programs, the distribution and magnitude of their benefits, their relative efficiency, their economic effects, problems related to their administration, and the extent to which they provide overlapping benefits either to the same recipients or with respect to the same transactions; and

References to selected bibliography.

Background Material on Tax Expenditures

The analyses in Part II of this compendium do not repeat the detailed information contained in the Part I summaries with respect to the tax expenditures that are discussed in the following 17 sections. In order to analyze more fully the relationships between the tax expenditures and spending programs compared in Part II, readers initially should refer to the summaries in Part I of the tax expenditures that are relevant to the Part II discussions. These Part I summaries provide descriptions of how the tax expenditures work, brief analyses of their impact, as well as the legislative history surrounding their enactment.

Choice of Topics

The 17 sections in this part cover a broad range of the Government policy areas affected by tax expenditures. They include discussions of more than half of the 84 tax expenditures described in Part I of the compendium. However, this second part is not intended to relate tax expenditures to spending programs in all areas in which such comparisons are possible.

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In most instances, the grouping of tax expenditures and spending programs into specific topic areas was suggested by the functional classifications and missions used by the Senate Budget Committee in its annual consideration of the Federal budget. The order in which the groupings appear is the same as Part I whenever possible. Thus, the first section compares military manpower tax expenditures to military manpower spending programs, and the second compares export tax expenditures to export spending programs.

In a few cases, however, the groupings depart from the functional or mission classifications used by the Budget Committee. For example, to compare job creation spending programs with related tax expenditures, the employment programs classified in function 500—education, training, employment, and social services—were analyzed, as well as other important spending programs classified under other budget functions, such as public works programs, classified under community and regional development (function 450), and the antirecession fiscal assistance program, classified with other revenue sharing programs under general government (function 850).

Certain tax and spending programs have been discussed principally within one of the 17 subject areas when at least one other alternative format was possible. For example, the education assistance benefits provided under the GI bill can be viewed both as a spending program benefiting veterans, and as a program related to higher education. The GI bill is discussed principally in the higher education section because it is the largest single Federal assistance program for higher education, and is directly comparable to other Federal education assistance spending programs and tax expenditures in its policy rationale and effects. Similarly, the tax expenditure allowing a tax deduction for property taxes on owner-occupied homes can be viewed both as a tax incentive for homeownership and as a general purpose fiscal assistance program enabling State and local governments to raise greater revenues through property taxes. This provision is discussed principally in the homeownership section because it is justified by legislators and policy analysts primarily as a tax subsidy program for homeowners, rather than as a fiscal assistance program, and it is as a homeownership incentive that the program has its greatest economic and policy impact.

However, the purpose of Part II of the compendium is not to categorize spending programs and tax expenditures as having the same goals and intent. Rather, the programs were grouped into 17 sections to facilitate the discussion and analysis of the relationships among the various programs.

Within some of the 17 sections, one or two tax expenditures and spending programs are given particular attention because the analyses of those programs highlight the importance of reviewing together tax expenditures and spending programs with significant interrelationships. One such instance, for example, involves the DISC export tax incentive and Export-Import Bank financing, which can both apply to the same export sale. Another is the relationship between the social security retirement system and integrated private pension plans, which benefit substantially from the favorable tax treatment allowed qualified private pension plans.

Relationships

A number of similarities exist in the relationships between the tax expenditures and spending programs in several of the sections in Part II.

First, the tax expenditure benefits often are distributed more heavily to higher income individuals than the benefits derived from spending programs related to the same area of Government policy. This is caused by a number of factors. Except for the earned income credit, tax expenditures only benefit individuals with tax liability. By contrast, spending programs benefit taxpayers and non-taxpayers alike.

Another reason for this general distributional effect is that numerous major spending programs benefiting individuals are needs-tested, while only a few tax expenditures are phased out for higher income individuals. However, those tax expenditures resulting from the exclusion from taxable income of needs-tested spending programs are themselves indirectly needs-tested, since they are only available to taxpayers who qualify for the spending benefits.

A third reason for this general distributional pattern is that all tax expenditures resulting from exclusions, exemptions, deductions, or deferrals increase in value to recipients in direct proportion to their marginal tax rates. (For an explanation of this effect see Appendix A to Part I of this compendium at pages 191–195.) On the other hand, direct payments have equal value for all recipients. In fact, when direct payments constitute taxable income to recipients, they are worth less in after tax value to recipients with higher marginal tax rates than to taxpayers with lower rates.

Several tax expenditures operate with less Government oversight and control than spending programs related to the same Federal policy areas. Spending programs often require trained employees to implement special program provisions and to evaluate grant applications and contract offers. By comparison, tax expenditures are claimed by the direct beneficiaries themselves through the filing of annual tax returns. Administration and enforcement of these tax programs are the responsibility of the Internal Revenue Service, which audits only a very small fraction of all tax returns. While administration of the tax expenditure programs often is relatively simple compared to that of the spending programs, to the extent oversight is less, the potential for fraud, abuse, and erroneously claimed benefits often is higher in the case of tax expenditures.

Finally, several of the sections in Part II indicate the important need for thorough Federal Government coordinated review of tax expenditure and spending programs related to the same policy areas. In some areas, it does not appear that much coordinated review occurs. For example, the analysis beginning on page 317 indicates that there is little data available on the impact of recent major social security law changes on private "integrated" pension plans, which benefit substantially from the tax expenditure for qualified pension plans.

The analyses in Part II are not intended to provide exhaustive reviews of the relationships between related tax and spending programs. Rather, they are intended to provide the background for subsequent more detailed studies of the relationships between these two types of programs. Selected bibliography is included at the end of each section to provide source materials for further analysis.

Cost Estimates

All outlay estimates provided in Part II have been provided by the Congressional Budget Office (CBO) except where otherwise noted. Each of the 17 sections contains a summary table of estimated outlays for fiscal years 1978–80. These outlay estimates were developed by CBO to assist the Senate Budget Committee in preparing the First Budget Resolution for Fiscal Year 1979.

Legislative Initiatives

In the case of most of the 17 sections, material has been provided under the heading "Legislative Initiatives" following the comparative analyses of the tax and spending programs. This material has been added only where Congress has been actively considering specific tax or spending law changes in 1978 or where the Administration formally has proposed legislative changes this year that would affect one or more of the programs discussed in a comparative analysis.

MILITARY MANPOWER

Tax Expenditures

Military compensation is enhanced in value by the exclusion from income tax of certain military benefits and allowances. This exclusion applies to certain in-kind benefits such as food and housing, and cash allowances made in lieu of these two items. A second military manpower tax expenditure results from the exclusion from taxable income of certain military disability pensions and a portion of retirement pay. These two tax expenditures are expected to result in revenue losses of approximately $1.5 billion in fiscal year 1979, as compared to direct outlays for military manpower of approximately $40.4 billion. Military manpower tax expenditures are discussed in greater detail on pages 9–12 in Part I of this compendium.

Spending Programs

The Department of Defense is expected to pay $37.1 billion to more than 4.1 million active, reserve, and retired military personnel in fiscal year 1979. An estimated additional $3.3 billion will be spent for the non-pay costs of personnel support (such as the costs of housing and medical care for military personnel and their dependents, etc.). The $40.4 billion military manpower budget accounts for about one-third of all national defense outlays. The following table lists the outlays for military manpower programs.

Estimated Outlays for Military Manpower

[In millions of dollars]

Program	1978	1979	1980
Active duty personnel compensation (pay and allowances)	23, 300	25, 000	26, 900
Retired military personnel compensation	9, 152	10, 100	11, 514
Paid-drill reservists compensation (pay and allowances)	1, 900	2, 000	2, 100
Personnel support costs:			
Housing (in-kind costs)	1, 500	1, 400	1, 500
Medical services	1, 500	1, 600	1, 700
Commissary and PX	300	300	300
Total	37, 652	40, 400	40, 014

ACTIVE DUTY PERSONNEL

Compensation for active duty personnel constitutes the largest component of military manpower costs. In fiscal year 1979, the Department of Defense (DoD) is expected to pay $25 billion to 2 million

active duty military personnel. DoD compensates active duty personnel in a variety of ways: basic cash pay, cash and in-kind allowances for food and housing, and allowances for special or hazardous work. The basic cash pay component is expected to account for 67 percent of active duty military compensation outlays in fiscal year 1979; cash and in-kind allowances for housing and food are expected to comprise an additional 8 percent each, with bonuses and other pay and special allowances expected to make up the remaining 17 percent of the active duty personnel budget.

Basic pay is the only cash component received by all active duty personnel, and constitutes compensation for work performed. Basic pay is tied to an individual's rank and years of service. As of October 1977, basic pay ranged from $398 per month for a new recruit to $3,958 per month for a four star officer with 26 years or more of service.

All active duty personnel also receive food and shelter allowances. When these goods are provided directly by the Government, allowances are said to be "in-kind." Otherwise, cash allowances are paid to help military personnel purchase these necessities on the private market. Allowances for food and housing are based on the individual's rank and the number of his dependents. About 40 percent of all enlisted personnel and 60 percent of all officers receive cash housing allowances which range from $82 per month for an unmarried enlisted person to $424 per month for a flag/general officer with dependents. Cash subsistence allowances for officers are $1.95 per day. Enlisted men receive between $2.84 and $3.20 per day when the military cannot provide food. All officers and approximately 56 percent of all enlisted men receive cash subsistence allowances.

In addition to basic pay and allowances, special pay and allowances are provided as compensation for work that is hazardous or that requires special skills. In order to retain experienced personnel, the military also provides bonuses to those who reenlist. The size of bonuses vary and is increased for individuals who choose longer reenlistment periods and for those with special or critically needed skills.

RETIRED MILITARY PERSONNEL

Outlays for retirement and disability pensions are expected to be $10.1 billion in fiscal year 1979. Approximately 89 percent of this total will go to individuals who retire without disability, to nondisabled reserve force retirees, and to the survivors of retirees. The remaining 11 percent will pay the retirement costs of disabled personnel.

Individuals without disability who leave the Armed Forces with less than 20 years of service receive no retirement pay. Individuals with 20 years or more of service receive a lifetime annuity, which begins immediately upon retirement. A retiree's annuity is 2.5 percent of his basic pay on the day he retires multiplied by his years of service. Hence, the annuity after 20 years of service is 50 percent of terminal basic pay, rising to a maximum of 75 percent with 30 years or more of service. After retirement, annuities are increased according to changes in the Consumer Price Index.

A disabled member of the military becomes eligible for disability compensation if his service determines that he has become physically

unfit to perform his duties. If the individual's disability is at least 30 percent, or he has at least 20 years of active service, he is eligible for disability retirement pay. Other disabled personnel are eligible for lump sum separation payments.

Disability pay is computed by multiplying the individual's basic pay by either the percentage of his disability or 2.5 percent per year of active service, whichever is larger, up to a maximum of 75 percent. In certain cases,[1] individuals may exclude disability pay, or that portion of retirement pay to which they would be eligible on the basis of disability, from taxable income. In fiscal year 1977, 14 percent of all military personnel receiving retirement pay were on disability.[2]

PAID-DRILL RESERVISTS

In addition to active duty military personnel, the United States currently employs about 820,000 paid-drill reservists, whose primary mission is to help defend this country and its allies during a national emergency. Upon declaration of a national emergency, these reservists may be called to active duty for as long as 2 years.

In peacetime, paid-drill reservists are on active duty only during an annual 2-week training period. During the remainder of the year, reservists are on "inactive duty" and drill only 1 weekend per month. When on active duty, reservists receive the same compensation as other active duty personnel. Reservists on "inactive duty" receive compensation based upon the number of drill periods they attend (most reservists attend 48 4-hour drill periods per year). For each drill period attended, a reservist receives one-thirtieth of the monthly basic pay to which he would be entitled if on active duty. Total DoD expenditures for paid-drill reservists are expected to be $2.0 billion in fiscal year 1979.

PERSONNEL SUPPORT COSTS

The non-pay costs related to the support of military personnel will be $3.3 billion in fiscal year 1979. These expenditures include the costs of maintaining quarters for military personnel, medical services for military members and their dependents, and support services on military bases.

Relationships Between the Tax Expenditures and Spending Programs

Distribution of Benefits

Direct military compensation is comprised of a cash pay component and allowances for quarters and food—provided either in-kind or in cash. The basic allowance for quarters (BAQ) and the basic allowance for subsistence (BAS) are exempt from tax, increasing total compensation through significant tax savings. Taken together, BAQ, BAS, the tax expenditure to which they give rise, and basic cash pay constitute regular military compensation (RMC). The concept of RMC was first established by Congress in 1967 to depict more clearly the cash value of military compensation. The table on page 209 shows the RMC of selected military personnel of different rank, dependency status, and service tenure.

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[1] See p. 11 of Part 1.

[2] Department of Defense, Office of Manpower, Reserve Affairs, and Logistics estimate. Retired personnel include nondisability retirees, permanently disabled, temporarily disabled, and fleet reserve retired persons.

The direct pay components of RMC are distributed to active duty military personnel according to specified compensation rates on the basis of rank, type of job, dependency status, and years of service.

In contrast to the direct pay components of RMC, the size of the related tax expenditure is not explicitly established by law or regulation. Rather, it is determined by an individual's marginal tax bracket; the higher an individual's marginal tax bracket, the greater is the value of excluding BAQ and BAS from taxable income. Military personnel without tax liability receive no related tax expenditure benefits. Thus, military personnel who are single or have outside income (from a working spouse, perhaps) benefit more from this military manpower tax expenditure than do married personnel and those who have no outside income who receive equal BAS, BAQ, and pay because the former are in higher marginal tax brackets.

Components of Regular Military Compensation, by Grade,[1] Annual Rates Effective Oct. 1, 1977, in Dollars

Pay grade	Title	Years of service	Number of dependents	Basic pay	Quarters allowance [2]	Subsistence allowance [2]	Average Federal tax advantage	Regular military compensation [3]
Officers:								
O-10	General	26	1	$47, 498	$5, 090	$714	$5, 757	$59, 060
O-8	Major general	26	2	41, 940	5, 090	714	5, 294	53, 039
O-6	Colonel	26	3	32, 040	4, 457	714	3, 314	40, 525
O-4	Major	14	3	20, 383	3, 622	714	1, 618	26, 337
O-1	2d lieutenant	(*)	1	8, 795	2, 326	714	623	12, 457
Enlisted personnel:								
E-9	Sergeant major	22	3	15, 790	3, 067	1, 037	1, 272	21, 165
E-7	Sergeant, 1st class	18	3	11, 452	2, 639	1, 037	896	16, 023
E-5	Sergeant	4	2	7, 114	2, 228	1, 037	744	11, 123
E-3	Private, 1st class	(*)	0	5, 522	1, 177	1, 037	484	8, 220
E-1	Private, E-1	(*)	0	4, 770	983	1, 037	415	7, 205

[1] The example shown for each grade represents a typical person in that grade.
[2] Quarters and subsistence allowances are based on cash rates. The values of in-kind allowances differ from cash rates; hence, RMC for those not receiving cash allowances would differ from the amounts shown in the last column.
[3] Because of rounding, details may not add to totals.

*Less than 2.

Source: Based on data provided by the Department of Defense, Office of the Assistant Secretary of Defense for Manpower and Reserve Affairs, October 1977; and Martin Binkin, *The Military Pay Muddle*, The Brookings Institution, Washington, D.C., 1975, p. 17.

Total RMC, therefore, varies according to a number of factors unrelated to the nature of an individual's job or rank. Single persons receive less direct pay than married personnel with the same rank, years of service, and job, both because their quarters allowance is less, and because single personnel have fewer dependents that can take advantage of free medical care and other fringe benefits. In contrast, the tax expenditure portion of RMC, which is determined by the recipient's tax liability, favors single over married personnel and those with outside income over those with none.

The tax expenditure that results from the exclusion from taxable income of certain military disability pension payments is concentrated primarily among moderate- and middle-income taxpayers. Low-income disabled military personnel without tax liability receive no benefits from this tax expenditure. According to the Treasury Department, over three-fourths of all military disability tax expenditures in fiscal year 1977 went to individuals with expanded gross income [3] between $5,000 and $20,000. Approximately 38 percent went to those with expanded gross income between $5,000 and $10,000 in this period.

The distribution of direct military disability pensions by income class is not currently available from the Department of Defense.

Efficiency

Because the magnitude of the tax expenditure related to military pay and allowances depends upon factors unrelated to an individual's particular job or service tenure, it introduces an element of uncertainty into military compensation. As a result, members of the military find it difficult to estimate the value of their compensation. A recent General Accounting Office study found that RMC was underestimated by significant numbers of enlisted personnel.[4] When the incentives offered by military compensation are unclear (as they appear to be here), it is more difficult and costly to recruit and retain military personnel. A simpler and more visible compensation system might provide greater incentives at the same cost, thereby improving the efficiency of the military pay system. Alternatively, by reducing the level of "hidden," in-kind benefits and cash allowances, DoD might be able to reduce costs while maintaining the current level of pay incentives.

The inefficiencies of the current military compensation system, in part a result of the variable value of tax-exempt "hidden" allowances and in-kind benefits, have long been recognized. Nearly every major report on military compensation to appear over the last several years has recommended restructuring the military pay and allowances system, including DoD's Third Quadrennial Review of Military Compensation, released in 1976.[5] Some of these studies, such as the report of the Defense Manpower Commission and a recent General Accounting

[3] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

[4] U.S. General Accounting Office, *Need To Improve Military Members' Perceptions of Their Compensation*, Report to the Congress by the Comptroller General of the United States, B-163770, Oct. 10, 1975, pp. 2–3.

[5] U.S. Department of Defense, Office of the Secretary of Defense, *Third Quadrennial Review of Military Compensation*, December 1976.

Office study of military compensation, have recommended replacing RMC with a single, fully taxable cash salary.[6]

Supporters of a salary system cite the benefits of simplicity, greater visibility, and cost savings as the primary reasons for changing the current system of compensation. They contend that a salary system would make military compensation both more efficient and more equitable in terms of equal pay for equal work. A fully taxable cash salary would eliminate the current biases that result from separate cash, in-kind, and tax expenditure components of military pay.

Advocates of the present military pay system raise several objections to a salary system. Most important, they argue that a salary system would create costly administrative problems. For example, if the quarters allowance were replaced by a salary, charges would have to be made for Government housing now provided in-kind to some military personnel. Since this housing varies widely in size and quality, it might be difficult to establish appropriate prices. Overpricing would lead to empty housing, while underpricing would provide a windfall to housing residents.

In addition, advocates of the current pay system argue that there would be transition problems in changing to a salary system. Many pay scales (retirement pay chief among them) are linked to basic pay. In switching to a salary system, new formulas for determining these pay scales would be required.

Selected Bibliography

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U.S. Congress. Congressional Budget Office. *The Cost of Defense Manpower: Issues for 1977*, January 1977.

———. *The Military Retirement System: Options for Change*, January 1978.

[6] *Report of the Defense Manpower Commission*, April 1976; U.S. General Accounting Office, *Military Compensation Should Be Changed to a Salary System*, Report to the Congress by the Comptroller General of the United States, FPCD-77-20, Aug. 1, 1977.

EXPORT PROMOTION

Tax Expenditures

The partial deferral of tax on the income of Domestic International Sales Corporations (DISC's) is a major tax expenditure intended to promote export sales. DISC exports accounted for approximately 69 percent of total U.S. gross export receipts in DISC year 1976.[1] Revenue losses resulting from the DISC tax expenditure account for a significant portion of total Federal financial support for general export promotion. The DISC tax expenditure is discussed in greater detail on pages 17–20 in Part I of this compendium.

Spending Programs

The major Federal programs intended to promote U.S. export trade are the various programs of the Export-Import Bank, the Commodity Credit Corporation short-term export credit sales program, and the food for peace program. These programs facilitate exports through a combination of short-, medium-, and long-term loans, grants, credits, guarantees, and insurance. In addition, a number of other programs, while primarily serving foreign aid and military assistance goals, also have a significant impact on the level of certain U.S. exports.

Outlays for the major Federal export programs are listed in the following table.

[1] U.S. Department of the Treasury, *The Operation and Effect of the Domestic International Sales Corporation Legislation: 1976 Annual Report*, April 1978, p. 1. DISC year 1976 refers to the period from July 1, 1975 through June 30, 1976. Because the majority of DISC's have tax years ending in December and January, roughly 86 percent of the exports reported in DISC year 1976 occurred in calendar year 1975.

Estimated Outlays for Export Promotion

[In millions of dollars]

Program	1978	1979	1980
Export programs: [1]			
Export-Import Bank	−104	254	642
Short-term agricultural credits	914	409	−67
Food for Peace	928	948	982
Total	1,738	1,611	1,557
Other programs aiding exports: [2]			
Military assistance	45	504	535
Other direct aid	3,826	3,980	4,466

[1] Gross credit market activity is in a number of ways a better measure of export assistance than are outlays. Gross credit activity reflects the sum of all loans obligated during a fiscal year under direct loan programs, or the value of all commercial loans or export shipments guaranteed or insured by Eximbank programs. Outlays, on the other hand, reflect only administrative costs and net lending activity—interest subsidies, loan defaults, new loans, and repayments on prior-year loans. As a result, outlay figures are highly influenced by prior-year lending activity and fluctuations in international currency exchange rates over time. Therefore, they do not accurately reflect a program's annual credit market activity. Indeed, some programs that have great influence on the availability of export credit show negative outlay costs in years when prior-year loan repayments, interest payments, and fees exceed the amount of total outlays necessary to cover new loans and guarantee payments. The gross annual credit activity of the 3 major export lending programs is listed in the table below.

[In millions of dollars]

Program	Credit activity		
	1978	1979	1980
Export-Import Bank [1]	7,865	9,500	10,100
Short-term agricultural credits [2]	1,700	1,500	1,250
Food for Peace [3]	1,160	1,157	1,256

[1] Expected authorizations, all Eximbank programs. Eximbank estimates.
[2] Expected credits. Commodity Credit Corporation estimates.
[3] Food for Peace, titles I and II (loans and direct grants), excluding ocean transportation costs. Commodity Credit Corporation estimates.

[2] Significant export stimulus is also generated by Government spending programs designed primarily as foreign aid and military assistance. While these programs are listed in the outlay table above, the degree to which outlays for programs providing military arms credits and bilateral aid should be considered under the category of export promotion is unclear.

EXPORT-IMPORT BANK

The Export-Import Bank (Eximbank) is a Government lending institution established in 1934 to facilitate the sale of U.S. products abroad. Eximbank offers three major services which aid prospective foreign buyers: (1) direct loans and export credits; (2) guarantees protecting commercial banks against loan defaults; and (3) credit insurance protecting domestic exporters against the political and commercial risks associated with large export sales.

Typically, a foreign buyer participating in an Eximbank direct credit transaction pays 10 to 15 percent of the total export purchase price, with Eximbank providing from 30 to 55 percent of the financing in direct loans or credits. The balance is financed by commerical financial institutions at market rates, usually in conjunction with Eximbank guarantees, insurance, or discount loans.

Eximbank credit programs are financed by borrowings from the Treasury, the Federal Financing Bank, and commerical banks, by interest and fee charges, by loan repayments, and by the $1.0 billion

in Federal stock subscribed in 1945. Eximbank loans carry interest rates above those charged to Eximbank by the Treasury for borrowed funds, so no direct costs to taxpayers are incurred. Similarly, guarantee and insurance fees generally cover the cost of commercial loan and credit defaults. However, Eximbank loans carry below-market interest rates which produce an indirect cost to the Government and a subsidy to purchasers. This indirect cost can, in theory, be measured by the difference between the interest charged borrowers on Eximbank loans and the higher return that would result if Eximbank loans carried market rates of interest.

Total Eximbank loan, guarantee, and insurance authorizations were $5.6 billion in fiscal year 1977 and $8.6 billion in fiscal year 1976. The value of export sales associated with all Eximbank credit programs was $8.5 billion in fiscal year 1977 and $12.0 billion in fiscal year 1976.[2]

The major Eximbank services are described below.

Guarantees and Insurance

In the past few years, Eximbank lending activities have increasingly focused on guarantees and insurance in an effort to involve the private sector in export promotion. Seventy-eight percent of total Eximbank authorizations in fiscal year 1977 were for guarantee and insurance services associated with $6.7 billion in export sales.[3] Insurance programs generally support short-term credits provided by private exporters with repayment terms of up to 5 years. Guarantees to commercial banks faciliate export loans of up to 5 years, with banks typically retaining a 15-percent share of lending risk.

Direct Loans

Eximbank direct loans help finance major capital purchases by foreign customers in conjunction with loans by U.S. commercial banks and other Eximbank financial guarantee and insurance programs. Repayment periods for major long-term capital projects range from 5 to 10 years following construction periods of 1 to 7 years, with interest rates currently between 7.75 and 8.75 percent. Eximbank approved 52 direct credit loans in fiscal year 1977, associated with $1.4 billion in export sales.[4]

SHORT-TERM AGRICULTURAL CREDITS

The Commodity Credit Corporation (CCC) short-term export credit sales program offers financing to foreign buyers for the purchase of surplus U.S. agricultural products. Interest rates are approximately equal to those charged by commercial lenders,[5] with repayment periods ranging from 6 to 36 months. Short-term export credits were associated with $621 million in agricultural sales in fiscal year 1976.[6]

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[2] *Export-Import Bank of the United States: 1977 Annual Report*, pp. 10–11.
[3] *Ibid.*
[4] *Ibid.*
[5] The Food for Peace Act of 1966 authorizes the CCC, under certain conditions, to provide short-term export credits to countries at below-market rates. Appropriations may be required to cover losses incurred under this authorization.
[6] U.S. Department of Agriculture, *Quarterly Report of the General Sales Manager: October 1–December 31, 1976*, January 1977, table 13.

FOOD FOR PEACE

The major U.S. program that deals with world hunger problems, Public Law 480 (commonly referred to as food for peace) offers low-interest, long-term loans to foreign countries for the purchase of agricultural commodities. With interest rates averaging 3 percent and repayment periods of up to 40 years, food for peace is essentially a grant program. Agricultural exports valued at $603 million were subsidized under this credit program in fiscal year 1976.[7] The food for peace program also provides direct agricultural grants.

MILITARY ASSISTANCE

The U.S. Government provides direct military credits and loan guarantees through the Department of Defense to allies and friendly nations for the purchase of military supplies and services. While primarily viewed as a component of U.S. foreign policy, these programs also support significant defense-related exports.

OTHER DIRECT AID

Other Federal agencies and programs that indirectly promote exports include: the Agency for International Development (AID), which administers the primary U.S. bilateral development assistance program; the security supporting assistance programs, which provide financial support to countries considered central to United States and world security (most funds now go to the Middle East); and multilateral aid programs, which support international financial institutions such as the World Bank.

Many of these bilateral programs increase export demand by the use of so-called "tied aid," which restricts the use of assistance funds to the purchase of American products. For instance, one recent study of the impact of U.S. bilateral aid programs on U.S. exports estimated that each dollar of AID development assistance results in a 50- to 90-cent increase in U.S. exports.[8] Even aid programs that are purely financial in nature (such as multilateral aid for international financial institutions) ultimately increase U.S. exports by providing foreign exchange to other countries.

Relationships Between the Tax Expenditure and Spending Programs

A comparison between DISC and Eximbank, the two major programs that promote general export sales, will be the primary focus of this section. Other spending programs that generate U.S. exports are generally associated with particular international or domestic policies other than export promotion. The short-term export credit sales program is, for the most part, a component of agricultural policy that decreases domestic crop surpluses, while the food for peace program is viewed primarily as a humanitarian aid program for lesser developed countries experiencing food shortages. Military assistance and bilateral/multilateral aid programs are fundamentally components of American foreign policy.

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[7] U.S. Department of Agriculture, *Budget Explanatory Notes for Fiscal Year 1978*, p. 220.

[8] Congressional Research Service, *The Impact of the United States Bilateral Development Assistance Program on U.S. Exports and Other Economic Variables*, by Raymond Ahearn and Warren E. Farb, Multilith 77-53, March 2, 1977. See also, Richard V. L. Cooper, "The Additionality Factor in Tied U.S. Development Assistance," Agency for International Development, Report No. 974, July 1972.

Distribution of Benefits

Government regulations limit DISC and Eximbank assistance to certain export sectors. Energy resources, such as oil and gas, and certain other natural resource products subject to the depletion allowance are denied DISC treatment, as are certain exports deemed to be in short supply. Eximbank financing is not available for certain defense-related products and services exported to lesser developed countries or for certain nuclear-related products.

Eximbank direct loans are concentrated in a few industrial sectors. DISC tax expenditure benefits, on the other hand, follow the general pattern of U.S. export trade and are distributed, therefore, across a wider range of industrial sectors. For example, transportation equipment accounted for about 15 percent of DISC receipts in fiscal year 1975, but over one-third of Eximbank direct loan purchases. In the same period, primary metals, fabricated metals, and heavy machinery accounted for one-third of all U.S. export revenues as well as about one-third of DISC revenue losses, yet these industries accounted for two-thirds of all Eximbank direct loan purchases.

Large firms receive the bulk of DISC benefits, as they generally account for the largest proportion of total U.S. export receipts. Sixty-six percent of net DISC income in DISC year 1976 accrued to 7.6 percent of the DISC's whose parent company assets were at least $250 million. Ten DISC parent corporations accounted for 22.5 percent of all DISC net income in the same period.[9] Similarly, large companies that manufacture aircraft, power plants, and other heavy capital good exports receive the bulk of the indirect benefits associated with Eximbank direct loan and credit programs.

There are no available data showing the distribution of Eximbank guarantees and insurance by size of export supplier.

Agricultural concerns benefit from loans and credits issued under the food for peace and short-term export credit programs, just as arms producers are the primary supplier beneficiaries of foreign military assistance. Approximately 86 percent of total food for peace funds were used to purchase wheat and rice in 1976, while 74 percent of all short-term export credits supported the purchase of wheat, cotton and tobacco.[10]

Efficiency

EFFECT ON EXPORTS

There is little conclusive empirical data regarding the effectiveness of U.S. export promotion programs in expanding exports. The large increase in exports over the last decade is often cited as evidence of the successful performance of export programs. However, the portion of export growth directly attributable to any one of these policies is very difficult to measure with any degree of accuracy given the uncertainties of the world trade market and the complex, interdependent economic effects of international export subsidies. Much of the increase in export trade over the past several years must be attributed to general inflation, the devaluation of the dollar, and the overall expansion of world markets.

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[9] *DISC 1976 Annual Report*, op. cit., p. 19.

[10] Congressional Budget Office, *U.S. Government Involvement in Commerical Exports: Program Goals and Budgetary Costs*, November 1977, pp. 13–14.

The DISC tax expenditure is intended to increase exports by lowering the effective corporate tax rate on export income, thereby increasing profit margins and attracting additional investment to the export sector. To the extent that tax savings are not only reflected in higher profit margins but are to some degree passed forward in lower product prices, U.S. exports should become more competitive, and export trade should generally increase.

Attempts to measure the incremental increase in exports resulting from DISC have produced varying results. For instance, the 1976 Treasury Department DISC report estimated the net increase in exports attributable to DISC in DISC year 1974 at $4.9 billion,[11] while a Congressional Research Service (CRS) study of the same period estimated a maximum net increase of only $1.4 billion.[12] By these estimates, the incremental increase in exports due to DISC was between 1 and 4 percent of total U.S. export trade for the period.

The most recent Treasury Department report estimates that the DISC program may have increased export trade by about $2.9 billion, or less than 3 percent of total U.S. exports, in DISC year 1976.[13] The report noted, however, that the $2.9 billion estimate overstates DISC's effect because it assumes no substitutibility between DISC and non-DISC exports. If a methodology were used that allowed for substitution, the impact of DISC on net exports would be between $0.4 and $0.9 billion, or less than 1 percent of total U.S. export trade for the period.

In contrast to the CRS and Treasury Department estimates, a report commissioned by the Special Committee for U.S. Exports, an association of export manufacturers, estimated the incremental increase in exports attributable to DISC in DISC year 1974 to be approximately $6.3 billion, or over four times the amount estimated by the Congressional Research Service.[14]

All of these estimates implicitly overstate the effects of the DISC program because they do not allow for flexibility in exchange rates, a point noted in the CRS and Treasury studies but not taken into account in their estimates.[15]

The effectiveness of Eximbank export financing is no less difficult to measure than that of DISC. A recent Treasury Department study estimated that all Eximbank programs together stimulated about $4 billion in U.S. export sales in fiscal year 1976 that would not otherwise have occurred.[16] The study found Eximbank's direct loan program far more effective in facilitating incremental export sales than its insurance and guarantee programs. It estimated that almost two-thirds of all U.S. export sales financed by Eximbank direct loans and credits in fiscal year 1976 probably would not have taken place without such support, resulting in $3.4 billion in additional exports. In contrast, the study indicated that only 31 percent of the guarantee program

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[11] *DISC 1976 Annual Report*, op. cit., Table B-3, p. 51.

[12] Congressional Research Service, *The Domestic International Sales Corporation and Its Effects on U.S. Foreign Trade and Unemployment*, by Jane Gravelle, et. al., Multilith 76-92E, May 4, 1976, pp. 1-3.

[13] *DISC 1976 Annual Report*, op. cit. p. 10.

[14] Norman B.Ture, Inc., *The Economic Effects of DISC*, a study commissioned by the Special Committee for U.S. Exports, September 17, 1975, p. 3.

[15] See page 221 below for a brief discussion of the impact of flexible exchange rates on export promotion programs.

[16] Dean A. DeRosa and William W. Nye, " 'Additionality' in the Activities of the Export-Import Bank of the United States," U.S. Department of the Treasury, attachment to statement by C. Fred Bergston, Assistant Secretary of the Treasury for International Affairs, before the International Trade, Investment, and Monetary Policy Subcommittee of the House Committee on Banking, Finance, and Urban Affairs, March 13, 1978, Table 4.

sales and 27 percent of the insurance program sales produced net additions to exports.[17]

The Congressional Research Service also recently estimated the effect of the direct credit portion of Eximbank financing on U.S. exports.[18] Using a different methodology than the Treasury, CRS estimated additional exports of only $670 million in fiscal year 1976 compared to the Treasury estimate of $3.4 billion.

Other export program analysts contend that the incremental increase in exports ("additionality") resulting from Eximbank programs, and particularly the incremental increase associated with insurance and guarantee programs, is substantially higher than that suggested by both the Treasury Department and CRS studies. They argue that Eximbank insurance and guarantee programs are necessary to offset the perception of excessive risk in the export credit market made by most commercial lenders, and that, therefore, these programs facilitate a large number of commercial loans that otherwise would be unavailable. Moreover, according to this point of view, a large number of U.S. exports financed by direct credits would be lost to foreign competitors in the absence of Eximbank assistance as a result of the significant export subsidy programs operated by most other major exporting countries.

TARGETING EXPORT PROGRAMS

The effectiveness of both tax and direct spending export promotion programs depends to a large degree on the extent to which program benefits can be targeted to transactions which would not have otherwise taken place. While no program can be perfectly targeted to such sales, a relatively large portion of the benefits of some programs may accrue to sales which would have occurred in any event.

As an untargeted tax expenditure available to virtually all exporters, DISC subsidizes a significant number of sales which would have taken place in the absence of the program. Although DISC was changed to an incremental tax expenditure in 1976 in an effort to minimize the inefficiency of such sales, it still rewards companies for all export income generated by receipts exceeding 67 percent of average gross receipts in a 4-year base period, regardless of whether the associated sales would have taken place in the absence of DISC. Moreover, although DISC subsidizes industries, such as capital goods, that encounter substantial foreign competition, it also heavily subsidizes industries, such as chemicals (23 percent of total DISC profits in fiscal year 1975), that have been experiencing very little competition in foreign markets. Where little significant foreign competition exists,

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[17] *Ibid.*, p. 7. The methodology of this study may have influenced the apparent disparity between loan and insurance/guarantee program effectiveness. The authors compared, on a case study basis, the magnitudes, repayment periods, and recipients of Eximbank credit services with the standard lending practices of several major banks. The basic approach of the comparison was to assume that a specified percentage of export sales facilitated by the various Eximbank programs was "additional" on the basis of certain characteristics of the financing arrangements, e.g., the length of loan, size of loan, and the country receiving the loan. The assumptions that determined which sales were "additional" were based on broad qualitative judgments, and the lower additionality of guarantee and insurance programs as compared to direct credit programs is reflective of these judgments. In addition, the authors did not account for adjustments that would occur in export lending markets in the absence of Eximbank programs. Such adjustments would tend to compensate to some degree for the lack of Eximbank financing, and thus the Treasury study probably overestimates the additionality of all Eximbank programs.

[18] Congressional Research Service, *Impact of Eximbank on U.S. Exports*, by Jane Gravelle, LTR 78-840, April 25, 1978.

export sales probably would occur regardless of whether or not assistance is available. DISC also subsidizes significant agricultural sales, thought by many experts to be relatively insensitive to any price changes DISC might facilitate.

The effectiveness of Eximbank in expanding exports is also in part dependent upon the targeting of its various lending programs. As originally conceived, Eximbank was to be a lender of "last resort," offering financial services at near market rates that would otherwise be unavailable in the private sector because of the excessive risk and political uncertainty associated with certain export transactions. However, in response to the increased competition among foreign governments in providing export subsidies over the past several years, Eximbank loans now carry below-market rates necessary to remain competitive. The result is that Eximbank is now sometimes a lender of "first resort," even to large, credit-worthy countries. As a lender of first resort, Eximbank's subsidized financial services may draw business away from traditional private creditors willing to finance exports at market rates; in these cases, benefits accrue to sales which would have taken place without Eximbank financing, producing no net increase in exports. Such situations occur particularly when financing is provided for sales when the United States is the sole supplier of the product or when financing is provided after sales contracts have been signed.[19]

The effectiveness of Eximbank insurance and guarantee programs is difficult to gauge. On the one hand, the low level of export additionally cited in the Treasury Department study above (see note 16 on page 218), suggests that a large number of insured and guaranteed Eximbank loans are of types normally held in commercial bank portfolios. On the other hand, although the size and repayment terms for these loans are not unusual, many smaller commercial banks and manufacturers are not willing to provide such funds for export sales without some type of government insurance or guarantee. In this regard, a study of export promotion programs by the Office of Management and Budget suggested that guarantee and insurance programs were often successful in providing commercial credit that would not otherwise have been forthcoming.[20]

The CCC short-term agricultural export credit program has not received as much attention as the DISC and Eximbank programs in studies of the effectiveness of export promotion policy. According to one point of view, the short-term export credit program is highly targeted, as financing is provided primarily to countries that do not otherwise have access to commercial credit, or that can receive credit only with substantial interest premiums resulting from commercial perception of excessive risk. According to this point of view, short-term credits finance sales that would otherwise be lost to foreign competitors, given the widespread use of international agriculture export subsidies.

On the other hand, since interest rates for short-term export credits are approximately equal to the market rate, the program may, to some extent, simply crowd out commercial agriculture lenders without producing a significant increase in exports.

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[19] For a discussion of Eximbank that focuses on program efficiency, see Douglas R. Bohi, "Export Credit Subsidies and U.S. Exports: An Analysis of the U.S. Eximbank," in Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 2—International Subsidies, June 11, 1972, pp. 157–175.

[20] U.S. Office of Management and Budget, *Interagency Report on U.S. Government Export Promotion Policies and Programs*, April 1975, revised, pp. III–13—III–17.

The issue of effectiveness is less controversial with respect to the food for peace program. This program is viewed primarily as a form of humanitarian assistance rather than as an export promotion program. In addition, the program is, for the most part, restricted to countries unable to meet market credit terms. Food for peace provisions require that 75 percent of all commodities sold under the program go to countries that meet the International Development Association poverty criterion. Therefore, even when viewed as an export promotion program, food for peace tends to facilitate sales that often would not occur without Government assistance.

IMPACT OF FLEXIBLE EXCHANGE RATES

The logic of any export promotion program must be examined in the present system of flexible exchange rates. DISC was formulated in 1971 to increase exports and help reduce the persistent U.S. balance of payments deficit caused by over-valuation of the dollar. With fixed exchange rates, an increase in export demand induced by lower prices afforded by DISC tax provisions would not affect the value of the dollar on international currency markets. However, with the shift to relatively flexible exchange rates, critics of DISC argue that any stimulated increase in export demand ultimately will result in the appreciation of the dollar on world markets, although this long-run response may take substantial time to occur. A more expensive dollar will make U.S. exports less attractive. This will increase the demand for relatively cheaper foreign imports and partially counteract the economic effect of the initial DISC-induced increase in exports.

Supporters of DISC argue that, on the other hand, exchange rates are in fact managed, that they are flexible only in theory, and that any currency adjustments will take such a substantial period of time as to not preclude positive effects from DISC.

Eximbank credit and guarantee programs, unlike DISC, are a form of foreign investment, since dollars used to finance Eximbank exports are loaned abroad under the terms of the programs. Since such capital exports tend to depreciate the value of the dollar, increased export demand induced by an Eximbank transaction is, in terms of the demand for dollars, offset by the depreciating effects of the export of capital. Therefore, there is relatively little increase in the demand for dollars on currency exchanges (since the dollars necessary to finance the purchase are provided under the terms of the program), and no resulting appreciation in the value of the dollar. As a result, export sales facilitated by Eximbank direct loan and guarantee programs are less likely in the short run to be offset through adjustments in exchange rates than are those facilitated by the DISC program.

LONGER RUN CONSIDERATIONS

The longer run effectiveness of DISC in increasing export trade is difficult to predict, since its effects are predicated on: (a) the amount of tax savings passed on in lower prices; (b) the sensitivity of export demand to price reductions; (c) the sensitivity of the value of the dollar to an increase in foreign demand for dollars necessary to purchase the new exports; and (d) the degree to which U.S. imports will increase with a given increase in the value of the dollar.

Similarly, the longer run effects of Eximbank financing are difficult to predict. To the extent that Eximbank acts as a lender of "first-resort," more profitable commercial financing by U.S. lenders may be crowded out, causing a comparative balance of payments loss.

Magnitude and Scope of Export Subsidies

Eximbank direct loan programs provide larger subsidies to fewer recipients than DISC. Somewhat over 10 percent of total U.S. exports receive Eximbank financial assistance. The magnitude of Eximbank loan subsidies is, in theory, the difference between the interest charged borrowers and the interest that would have been paid if these funds were loaned domestically at the market rate. The Congressional Budget Office estimated that in 1975, $2.69 billion in direct Eximbank loans, which assisted $6.97 billion in exports, resulted in export subsidies of $638 million.[21] This subsidy as a percentage of the total export value associated with Eximbank sales in that year is equivalent to a 9.2-percent average price reduction.

It is difficult to measure the extent to which insurance and guarantee programs provide an export "subsidy." Fees charged for Eximbank insurance and guarantee services generally reflect actuarial risk, and, therefore, these services do not themselves provide any direct subsidy. On the other hand, private commercial export loans guaranteed by Eximbank generally carry an interest rate approximately 1 percent below normal commercial rates. This reduction in the cost of commercial credit might be viewed as reflecting the subsidy value to the commercial lender of the Eximbank insurance or guarantee and, therefore, could be interpreted as a measure of the indirect insurance or guarantee subsidy.

In contrast to Eximbank programs, which subsidize only about 10 percent of total U.S. exports, DISC benefits accrued to over two-thirds of total U.S. exports in DISC year 1976, before DISC was placed on an incremental basis. However, the average value of the DISC subsidy for manufactured products was estimated to be only 2 percent, reflected in both lowered prices and increased profits.[22]

It is difficult to accurately estimate the change in the value of the DISC subsidy since its conversion to an incremental tax expenditure. The Treasury Department estimates that the incremental rule will reduce the export subsidy effect of DISC at the margin, since an additional current dollar of exports will increase the export base and reduce DISC benefits in the future. Based on this analysis, the DISC subsidy would drop by one-third to about 1.3 percent of the value of gross DISC export receipts.

Like Eximbank, the food for peace program is more concentrated in its distribution and subsidy value than DISC. The $1.3 billion in 1975 food for peace grants and loans accounted for only 7 percent of total U.S. agricultural exports and 1 percent of total exports in the period. The grant portion of food for peace aid provides a 100-percent subsidy, and the 3 percent average food for peace lending rate

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[21] *U.S. Government Involvement in Commercial Exports*, op. cit., p. 11.

[22] The 1976 DISC annual report measured the DISC net income for manufactured products sold through DISCs at 8.2 percent of gross receipts. The value of indefinitely deferring one-half of the tax on net income would be 24 percent of that amount, or 2 percent of the value of gross receipts. See *DISC 1976 Annual Report*, op. cit., p. 41.

produced a subsidy of $303 million on $603 million in 1975 loans, measured as the difference between the Treasury and the food for peace lending rates. If the subsidy were measured as the difference between the commercial market rate and the food for peace rate, it would be much larger.

Geographical Destination of Exports

Export promotion programs such as DISC and Eximbank can be considered a form of foreign aid to the extent they provide U.S. products to foreign governments or private purchasers at reduced costs. DISC tax benefits are, in theory, partially passed forward to foreign purchasers in the form of lower prices. Eximbank credit programs allow buyers in foreign countries to finance U.S. export purchases with borrowed funds at market or below-market rates which might not otherwise be available.

When viewed as foreign aid, the geographical distribution of DISC export subsidies differs substantially from that of Eximbank assistance, with a far greater percentage of DISC exports going to developed, industrialized countries. Moreover, neither of these two export programs is generally restricted to developing countries as are more explicit U.S. foreign assistance programs.

The geographical distribution of DISC benefits follows general U.S. export patterns. In 1974, sales to Canada, Western Europe, and Japan accounted for 60 percent of both total U.S. exports and DISC receipts.[23] By comparison, only a quarter of Eximbank loans, on average, go to these developed countries.[24] Canada, Western Europe, and Japan receive virtually no benefits of any export or foreign aid program other than Eximbank and DISC.

A significant portion of Eximbank financing is provided to Eastern European countries in an effort to facilitate East-West trade and achieve certain foreign policy goals. Latin America, Africa, and Asia (excluding Japan) receive about two-thirds of total Eximbank support and virtually all direct U.S. foreign aid, but only about a third of DISC exports go to these regions.

Overlap of Benefits

The DISC statute empowers the Secretary of the Treasury to deny benefits to any export receipts "accomplished by a subsidy granted by" the U.S. Government. The Treasury Department has designated export receipts generated by AID and military assistance programs, food for peace, the short-term export credit program, and several other Government export programs as ineligible for DISC benefits under this provision.[25] However, the Treasury has not disqualified Eximbank-financed sales for DISC tax treatment. Therefore, Eximbank-financed exports also can qualify for DISC tax benefits.

The DISC tax subsidy accrues directly to exporters in the form of reduced tax liability. The direct benefits of Eximbank credit programs, on the other hand, accrue to foreign buyers in the form of loans, credits, guarantees, and insurance. In both cases, however, benefits are likely

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[23] *DISC 1976 Annual Report*, op. cit., p. 41.
[24] *U.S. Overseas Loans and Grants Obligations and Loan Authorizations*, July 1, 1945–September 30, 1976.
[25] The Treasury does allow DISC benefits for sales generated by AID and military assistance under certain special competitive market conditions.

to ultimately accrue to both seller and purchaser. To the extent that U.S. exporters indirectly receive the benefits of Eximbank credit programs measured in terms of increased export sales, U.S. exporting companies receive significant overlapping financial assistance as a result of both Eximbank and DISC.

There is no empirical research on the percentage of Eximbank-financed exports that also receive DISC benefits. However, large U.S. capital goods manufacturers, which supply the bulk of the products financed under Eximbank loan and credit programs, receive a significant portion of the total DISC tax benefits, suggesting that substantial overlapping benefits often accrue to the same export transactions.

Legislative Initiatives

The Carter Administration's 1978 tax program recommended repeal of the DISC tax expenditure. Arguing that the rationale for DISC is no longer justified under the existing system of flexible exchange rates, the Administration proposed it be phased out over a 3-year period beginning in 1979.

In urging the repeal of DISC, the Administration argued that Eximbank loan and guarantee programs are clearly preferable to DISC as a means of encouraging exports and improving the U.S. balance-of-payments deficit. The Administration contended that Eximbank programs can be more effectively targeted to particular export sectors or countries and more easily adjusted in response to shifts in the U.S. balance-of-trade posture.[26]

Consistent with this position, the Carter Administration also has proposed a 5-year extension of the Export-Import Bank Act through September of 1983 and an increase in the statutory ceiling that limits the amount of outstanding loans, insurance, and guarantees from the current $25 billion to $40 billion.[27] This increase in commitment authority would allow Eximbank programs to grow at an annual rate of about 10 percent over the next 5 years.

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[26] U.S. Department of the Treasury, *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*, January 30, 1978, p. 276.

[27] Under the current Export-Import Bank Act, direct loans and credits are charged against the $25 billion ceiling at 100 percent of their authorized amount, while insurance and guarantee commitments are charged at not less than 25 percent of Eximbank's contractual liability. The aggregate amount of insurance and guarantees charged at 25 percent may not, however, exceed $20 billion outstanding at any one time.

ENERGY SUPPLY DEVELOPMENT

Tax Expenditures

Tax expenditures are the primary component of Federal energy policy intended to stimulate the supply and availability of traditional energy sources such as coal, oil, and natural gas. The major energy supply tax expenditures are the excess of percentage depletion over cost depletion, and the expensing of intangible drilling costs and exploration and development costs.[1] These provisions account for over 97 percent of the revenue losses associated with energy supply tax expenditures. Another tax expenditure affecting energy supply is the capital gains treatment of coal royalties. Revenue losses associated with energy supply tax expenditures are expected to reach $2.9 billion in fiscal year 1979 compared to an estimated $4.3 billion in net direct outlays.[2] Energy supply tax expenditures are discussed in greater detail on pages 29–38 in Part I of this compendium.

Spending Programs

Federal outlays related to energy supply support programs in two general policy areas: (1) energy research, development, and demonstration; and (2) public sector commercial activities. The following table lists outlays for these general energy supply spending program areas.

Estimated Outlays for Energy Supply Development

[In millions of dollars]

Program	1978	1979	1980
Research, development, and demonstrations	2, 536	3, 069	3, 402
Commercial activities:			
Uranium enrichment	1, 430	1, 451	1, 674
(Uranium enrichment receipts) [1]	(966)	(1, 209)	(1, 250)
Petroleum reserves	228	333	236
(Petroleum reserve receipts) [1]	(490)	(552)	(634)
Power marketing	999	1, 165	1, 308
Total (net)	3, 737	4, 257	4, 736

[1] Parentheses denote program receipts (negative outlays).

[1] The tax expenditure excluding interest on State and local debt from taxable income can be considered an energy supply tax expenditure to the extent that State and local governments finance public utilities and power operations by issuing tax-exempt bonds. Approximately 13 percent of all State and municipal bonds were issued for gas and electric utility purposes in fiscal year 1979. This tax expenditure is discussed on pages 347–358 of Part II in the section on general purpose fiscal assistance tax expenditures and related spending programs.

[2] The net outlay estimate reflects $6.0 billion of gross outlays for energy supply activities offset by receipts of $1.7 billion from the sale of enriched uranium, petroleum reserves, and Federal power utility services.

RESEARCH, DEVELOPMENT, AND DEMONSTRATIONS

The Federal Government finances extensive research and development projects aimed at discovering new sources of energy as well as alternative technologies for more efficient energy use. In addition, the Government funds major demonstration facilities to test the economic and technological feasibility of various alternative energy project proposals. Federal energy research and development concentrates primarily on projects requiring long-term development periods, large capital investments, and high technical and financial risks. Nearly three-fourths of the net outlays for energy supply will support research and development projects in fiscal year 1979.

The major areas of energy supply research, development, and demonstrations are: (1) advanced fission and alternative nuclear technologies, such as the liquid metal breeder reactor; (2) inexhaustible resources—the development of solar, wind, ocean, and geothermal power, small hydropower, the use of organic waste products and crops for fuel, and nuclear fusion power; (3) fossil fuels, including coal conversion (liquefaction and gasification) and alternative methods of coal utilization; (4) environmental consequences of alternative forms of energy; and (5) supporting technology—the basic conceptual research and testing underlying more specific energy projects.

COMMERCIAL ACTIVITIES

Federal commercial activities include: (1) Federal facilities for the production and sale of enriched uranium for use in foreign and commercial nuclear power plants; (2) production, exploration, and sale of federally owned petroleum reserves in California, Wyoming, and Alaska; and (3) several power marketing programs, the most significant of which are the nuclear power plant construction programs of the Tennessee Valley Authority and several Federal hydroelectric power projects.

Relationships Between the Tax Expenditures and Spending Programs [3]

Rationale

Federal energy supply policy focuses on four often conflicting goals: (1) to provide an abundant supply of energy at relatively low prices in the short-term; (2) to reduce dependence on imported petroleum products by building reserves of traditional energy fuels, thereby minimizing the effects of possible supply disruptions; (3) to prepare for higher energy prices in the intermediate-term which will result from continuing growth in energy demand coupled with declining world oil and gas supplies; and (4) to develop long-term renewable and inexhaustible sources of energy for sustained growth through the next century.

Direct spending for research and development focuses primarily on the long-term development of renewable and inexhaustible future

[3] Although Federal commercial energy activities often result in significant outlays, these programs are not major components of Federal energy supply policies since, in general, these are activities undertaken in the public sector for reasons not directly related to energy supply program goals. For instance, enriched uranium production is publicly rather than privately run in part for national security reasons, while many of the power facilities of the Tennessee Valley Authority were originally a component of economic recovery policy in the 1930's. Accordingly, this section will concentrate on the comparison between the major energy supply tax expenditures and Federal research, development, and demonstration programs.

energy sources. Few of the energy sources emphasized by these programs are expected to play a significant role in meeting short- or intermediate-term energy needs. For example, nuclear power, a major focus of energy supply research and development, accounted for less than 4 percent of domestic energy use in 1977, and its contribution by 1990 is likely to be no more than 10 percent. Renewable resources, oil shale, and synthetic fuels are not expected to make a major contribution to U.S. energy needs in this century.

The major energy supply tax expenditures, on the other hand, concentrate primarily on expanding the short-term availability of traditional energy sources. The tax expenditure subsidy provided by the expensing of intangible drilling costs and exploration and development costs tends to increase the quantity of oil and gas reserves, somewhat reducing U.S. dependence on foreign energy imports in the short run.

The relationship of the percentage depletion tax expenditure to Federal energy policy is somewhat ambiguous. On the one hand, it increases the profitability of investment in oil, gas, and coal, thereby increasing reserves of traditional energy sources in the short run. On the other hand, since percentage depletion tax benefits are calculated on the basis of oil, gas, and coal sales, this provision tends to expand energy consumption and lower fuel prices in the present, depleting domestic reserves available for potential future use.

At present, no spending programs focus primarily on providing adequate energy supplies in the intermediate period. At this stage, oil and gas reserves are likely to have dwindled significantly, but new technologies under development by Federal research programs will probably still be years away from widespread commercial use. Most experts believe that coal and commercial nuclear power will be the major sources of energy during this period, but these are given relatively minor emphasis in the present allocation of direct spending energy supply funds. However, new coal conversion and conservation programs intended to relieve some of these intermediate-term energy problems are a primary focus of several current legislative initiatives.

Although coal and nuclear power have accounted for a relatively small portion of total energy supply tax expenditure revenue losses in the past, the portion has increased in recent years, and the application of the depletion allowance tax expenditure to coal and nuclear fuel production will continue to increase in this intermediate period if sales of coal and nuclear materials substantially increase.

Types of Energy Affected

Tax expenditures and spending programs intended to increase energy supply differ substantially in their emphasis on different types of fuel. The Treasury Department estimates that of the $1.1 billion in expected revenue losses resulting from the percentage depletion tax expenditure for energy fuels in fiscal year 1978, $687 million will benefit oil and gas production, $410 million will benefit coal production, and $17 million will subsidize uranium production. Nearly all of the $1.2 billion revenue loss from the expensing of drilling and exploration costs will benefit oil and gas production. Therefore, including the $65 million tax expenditure for the capital gains treatment of coal royalties, 99 percent of these tax expenditure benefits will subsidize traditional energy fuels, with less than 1 percent of the total benefits

supporting uranium production. Approximately 80 percent of the total tax expenditure benefits will subsidize oil and gas supply alone in fiscal year 1978.

Spending programs, on the other hand, primarily emphasize nontraditional forms of energy supply. Advanced fission technology and waste disposal accounted for approximately 41 percent of research, development, and demonstration expenditures in fiscal year 1977, with renewable resource research receiving 20 percent. Only 21 percent of these funds supported fossil fuel research, barely more than the 19 percent allocated to environmental and other supporting activities. Moreover, a significant portion of the outlays for fossil fuel research emphasized nontraditional energy sources such as liquified and gasified coal, and oil and gas shale.

Efficiency

The efficiency of long-term, large-scale research, development, and demonstration projects is very difficult to measure. High financial and technical risk coupled with large capital requirements make most large-scale projects unattractive investments for the private sector, so no market measure of relative efficiency is possible.

The efficiency of tax expenditures in expanding short-term energy supply through investment in oil and gas production has been criticized on several grounds by numerous economists and energy analysts. The portion of tax expenditure benefits that results in increased royalty rent is said to have little direct effect on the supply or price of oil, gas, or coal. One expert concluded that 40 percent of the benefits of percentage depletion are generally reflected in increased royalties, with 10 percent reflected in increased after-tax profits, and 50 percent reflected in price reductions.[4] Moreover, given the price increases in oil since 1973, critics argue that substantial financial incentives for exploration and production exist without supplementary tax incentives, and that these tax expenditures simply result in increased profits and royalties without expanding net supplies or reserves.

Supporters of the present energy supply tax expenditures argue, on the other hand, that tax incentives are necessary to compensate investors for the high corporate taxes on oil and gas companies relative to other investment sectors, which are a result of the high profit to price ratios necessary in the energy sector for continued capital investment. Moreover, they argue that tax expenditures are necessary to compensate investors for the riskiness of oil, gas, and coal exploration in general.[5]

Some economists also have suggested that direct spending program alternatives may be more efficient than existing energy supply tax expenditures in stimulating additional energy reserves. Two recent studies concluded that higher levels of petroleum reserves could be attained more efficiently through direct storage reserve contracts with private firms than through existing tax expenditure provisions.[6]

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[4] Gerard M. Brannon, *Energy Taxes and Subsidies*, Ballinger, Cambridge, Mass., 1974, p. 41.

[5] John McLean, Continental Oil Co., Testimony before the House Ways and Means Committee, in *General Tax Reform*, Panel Discussions, Part 9—Natural Resources, 93d Cong., 1st sess., Feb. 26, 1973, pp. 1253–54; Richard Gonzales, *Ibid.*, pp. 1349–54; S. McDonald, "Distinctive Tax Treatment of Income from Oil and Gas Production," *Natural Resources Journal*, January 1970, pp. 97–112.

[6] James C. Cox and Arthur W. Wright, "The Cost-Effectiveness of Federal Tax Subsidies for Petroleum Reserves: Some Empirical Results and Their Implications," in *Studies in Energy Tax Policy*, Gerard Brannon, ed., Ballinger, Cambridge, Mass., 1975, pp. 177–197; Robert M. Spann, Edward W. Erickson, and Stephen W. Millsaps, "Percentage Depletion and the Price and Output of Domestic Crude Oil," in *General Tax Reform*, op. cit., pp. 1309–28.

The percentage depletion tax expenditure is viewed as particularly inefficient in increasing energy reserves compared to direct spending alternatives because it tends to increase production as well as reserves, thereby using up nonrenewable fossil fuels more quickly than would otherwise be the case.

Because tax expenditures, in general, increase the supply of oil and gas on the market, they tend to lower fuel prices and encourage consumption. A direct spending petroleum reserve policy, on the other hand, would reduce somewhat the supply of oil presently available on the market, thereby increasing prices slightly and discouraging present consumption. Therefore, to the extent energy supply tax expenditures increase present consumption, they conflict with other Government policies intended to slow present consumption of energy and build future reserves.

Legislative Initiatives

The energy tax legislation approved by the Senate in November 1977 and now in Congressional conference contains a number of tax expenditure programs aimed at increasing the supply of nontraditional energy sources. The major energy supply tax expenditures in the Senate bill are: the tax credits for the production of oil shale and geopressurized methane gas; exemptions for interest on industrial development bonds issued to construct coal gasification and liquefaction facilities, for bioconversion facilities that produce energy from waste products, and for local electric and gas supply plants; and deductions for intangible drilling and exploration costs associated with geothermal energy and geopressurized methane.

Also included in the Senate bill are proposals for two major additional investment tax credits [7] for certain types of energy property. These credits are intended to encourage modification of existing structures and equipment in order to increase energy efficiency and to promote industrial conversion from oil- and gas-powered facilities to those using coal and other nonpetroleum or renewable resources.

The principal nontax components of the energy legislation now under consideration by the Congress associated with energy supply operate primarily through coal conversion guidelines and requirements and changes in natural gas and oil pricing policies. Significant increases in outlays for current energy supply direct spending programs, particularly in the areas of coal and solar energy research and technology, are expected in fiscal year 1979 in addition to the initiatives under consideration by the present Congress.

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[7] These credits would be in addition to the 10 percent general investment tax credit presently in effect.

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POLLUTION CONTROL

Tax Expenditures

Pollution control tax expenditures reduce the cost to private firms and utilities of building new pollution control facilities and bringing existing facilities into compliance with Federal environmental standards. These tax expenditures are currently a minor component of Federal pollution control and abatement policy, accounting for less than 5 percent of total tax and direct Federal spending in this area. However, these tax expenditures are expected to more than double in the next several years, from approximately $360 million in fiscal year 1979 to $725 million in fiscal year 1983.

The major pollution control tax expenditures are the 5-year amortization for pollution control facilities [1] and the exclusion of interest on State and local government pollution control bonds. These two provisions account for over 97 percent of the revenue losses associated with pollution control tax expenditures. In addition, the 1976 Tax Reform Act included a relatively minor new tax expenditure allowing utilities to exclude from tax some payments made to them in connection with the construction of sewage disposal facilities.

Pollution control tax expenditures will result in total revenue losses of approximately $360 million in fiscal year 1979, compared to $5.7 billion in expected outlays for pollution control and abatement spending programs. Pollution control tax expenditures are discussed and analyzed in greater detail on pages 39–46 in Part I of this compendium.

Spending Programs

National pollution control policy is carried out through a combination of regulatory standard and enforcement programs, grants to local governments for the construction of sewage treatment facilities, and long-term pollution control research and development projects. Outlays for these three major types of pollution control programs are listed in the following table.

Estimated Outlays for Pollution Control and Abatement

[In millions of dollars]

Program	1978	1979	1980
Financial aid to State, interstate, and local governments	3, 870	4, 183	4, 560
Research and development	162	309	242
Standard setting and enforcement	554	625	717
Other [1]	526	584	([2])
Total	5, 112	5, 701	([2])

[1] Includes Office of Management and Budget estimates of pollution control outlays for Federal facilities.
[2] Unavailable.

[1] Businesses that elect rapid amortization for pollution control equipment are limited to one-half the full 10 percent investment tax credit for qualifying equipment.

FINANCIAL AID TO STATE, INTERSTATE, AND LOCAL GOVERNMENTS

Approximately two-thirds of all Federal pollution control outlays are direct grants to jurisdictions for the construction of sewage treatment plants. Grants are administered by the Environmental Protection Agency (EPA) and reimburse 75 percent of the total construction costs. Funds are allocated to States according to a formula based 75 percent on need and 25 percent on State population. Funds for specific projects are then approved from State allocations. Some 12,000 projects are currently funded under the EPA program.

A relatively small number of direct EPA grants also help fund State and local pollution control agencies that monitor and enforce air and water quality standards.

RESEARCH AND DEVELOPMENT

The Federal Government funds research, development, and demonstration projects to improve pollution control and abatement techniques. These projects concentrate primarily on: (1) improving existing techniques of pollutant identification; (2) developing more efficient technologies for pollution control; and (3) developing new methods and procedures for monitoring the emission of pollutants and enforcing regulatory standards.

STANDARD SETTING AND ENFORCEMENT

Outlays for standard setting and enforcement primarily fund the monitoring and surveillance activities necessary to enforce existing Federal air and water quality standards for private industry. The Environmental Protection Agency is primarily responsible for standards enforcement, with the Occupation Safety and Health Administration and the Department of Energy also receiving funds for related enforcement activities.

OTHER POLLUTION CONTROL OUTLAYS

The remaining Federal outlays for pollution control are primarily funds to enable Federal facilities to comply with existing Federal, State, and local environmental regulations. Over two-thirds of the outlays for the control of pollution from Federal facilities go to the Department of Defense for Air Force air and noise pollution control, Army munitions plant pollution control, and improved Navy sewage systems.

Relationships Between the Tax Expenditures and Spending Programs [1]

Rationale

National pollution control policy is carried out through a variety of measures. The most important components of pollution control policy are: (1) the establishment and enforcement of air and water quality standards; (2) direct grants to local governments for construction of sewage treatment facilities; (3) tax expenditures to aid

[1] The exclusion of payments to utilities to aid in the construction of water and sewage facilities will not be a focus of this discussion because of its relatively small revenue effect compared to the other tax expenditures discussed in this section.

private industry in pollution control efforts; and (4) research and development.

The rationale behind the strong environmental regulatory legislation of the past decade is that producers should bear the costs necessary to reduce pollution for which they are responsible. Thus, Federal air and water quality regulations impose fines on businesses that emit pollutants exceeding specified allowable levels.

Federal expenditures for pollution control—either through direct outlays or tax expenditures—represent a departure from this principle that polluters should bear the expense of controlling their effluents. Programs such as the EPA grants for sewage treatment facilities or the exclusion of interest on pollution control bonds relieve the polluter of part of the costs of preventing pollution. These costs are, instead, placed on the general public. The shifting of costs from polluters to the public is justified by some as a transition measure.

To the extent that the costs to producers of complying with air and water pollution standards are passed on in the form of higher prices for the goods produced, these costs are paid by the consumers of the particular product. Most economists argue that prices that reflect pollution control costs are an appropriate measure of the true social cost of producing the goods.

Distribution of Benefits

Tax expenditures for pollution control subsidize private sector pollution abatement efforts by lowering the cost to businesses of financing pollution control facilities. Spending programs, in contrast, focus almost exclusively on public sector pollution control by reducing the cost to State and local governments of building sewage treatment facilities and monitoring Government regulatory standards. To the extent that both public and private expenditures for pollution control depend on prevailing regulatory standards, the magnitude of both tax expenditures and direct outlays can be expected to rise if standards become more stringent.

The exclusion of interest on pollution control development bonds lowers the cost of constructing and leasing pollution control facilities for businesses that guarantee these bonds. In addition, some of the benefits of this tax expenditure accrue to individuals and institutions that purchase tax-exempt pollution control bonds.

Approximately one-third of the revenue losses resulting from the exclusion of interest on pollution control bonds will accrue to individual taxpayers in fiscal year 1979. The bulk of these benefits will accrue to upper income taxpayers. Since these bonds pay a lower, tax-free rate of interest than comparable taxable bonds, individuals in relatively lower marginal tax brackets (usually under 30 percent) will generally receive a higher after-tax return from interest-bearing taxable investments. As a result, largely higher income investors are attracted to pollution control bonds. The benefits also accrue largely to higher income taxpayers because the value of the tax exclusion increases with an investor's marginal tax bracket. In fiscal year 1977, 87 percent of the individual benefits of this tax expenditure went to taxpayers with expanded gross income [2] exceeding $50,000. Fire and

[2] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

casualty insurance companies are the largest institutional investors in pollution control bonds.

In contrast to tax-exempt pollution control bonds, outside investors do not benefit from the other major pollution control tax expenditure or from direct Federal pollution control subsidies. The benefits of the 5-year amortization tax provision accrue only to businesses that invest in pollution control equipment, while the bulk of direct spending funds go directly to Government jurisdictions for sewage treatment construction and environmental regulation.

The 5-year amortization of certain types of pollution control equipment helps bring existing industrial facilities into compliance with relatively new environmental standards. Under the 1976 Tax Reform Act, this amortization provision is available only for new equipment or facilities installed in a plant in operation prior to 1976. In contrast, direct spending for sewege facilities subsidize the construction of new pollution control facilities. Tax-exempt pollution control bonds may be used to finance pollution control equipment for both new and already existing facilities.

Efficiency

The rapid amortization subsidy for pollution control equipment generally favors end-of-the-process controls rather than early-in-the-process changes in production techniques. Integral remedies, which reduce pollution by altering the production process, are not subsidized as are remedies which simply "add-on" pollution control devices without making significant production process changes. Although an add-on facility, given the tax subsidy, may cost less for the producer in the short-run, the long-run costs of controlling pollution to taxpayers and producers together may be less with a substantially revised process. Critics argue, therefore, that the rapid amortization provision is not neutral with respect to alternative measures to reduce pollution and that it, therefore, often subsidizes inefficient forms of pollution abatement.

This criticism was muted somewhat by the extension of rapid amortization to fuel cleaning equipment under the 1976 Tax Reform Act, but the costs of simply purchasing cleaner fuel still are not subsidized in a comparable fashion. Facilities eligible for 5-year amortization still may not, under present law, undergo significant alterations in the nature of their manufacturing process or their basic facility and receive tax expenditure benefits under this provision.

Federal subsidies provided through tax-exempt industrial development bonds are similar to the rapid amortization rules in that only specifically designated "pollution control" equipment is eligible for tax-exempt financing. However, to the extent that these bonds finance pollution control equipment for new facilities designed to take into account existing environmental regulations, these restrictions are less likely to adversely affect the choice of appropriate, cost-efficient industrial technology than in the case of the rapid amortization tax provision.

Direct spending grant programs, in contrast to the tax expenditures, are relatively neutral with respect to the type of pollution technology subsidized. Recipients of direct Federal funding are, therefore, more likely to employ the most cost-efficient equipment available in meeting pollution quality standards, unless constrained by EPA regulations.

The 5-year amortization tax expenditure is intended to hasten compliance with existing regulatory standards as well as provide financial relief to businesses that must install pollution equipment to comply with these standards. Since the benefits of this tax expenditure accrue only to businesses that purchase pollution control equipment and not to outside investors, it is relatively effective in providing financial relief commensurate with the burden of regulatory compliance. However, there have been no studies to determine whether this provision has hastened the speed with which producers are complying with existing regulatory standards.

By comparison, the exclusion of interest on pollution control bonds is a more inefficient tax approach to pollution abatement policy because a portion of the subsidy intended for producers who lease pollution control facilities is "captured" by high-income individuals and institutions who purchase the bonds, thereby diluting the magnitude of the benefits for polluters. The percentage of the total Federal subsidy that accrues to users of pollution facilities depends on the difference between taxable and tax-exempt bond yields on the current bond market—the greater the differential, the larger the percentage of the subsidy that accrues to the users and the smaller the percentage that accrues to bond purchasers in the form of tax-exempt interest payments.[3]

Direct cost sharing grants, like the 5-year amortization tax expenditure, are relatively effective in providing Federal subsidies directly to the builders of sewage facilities; none of the intended subsidy is captured by upper income taxpayers or institutional investors. This program also supplies funds where they are most needed, since grants for sewage facility construction are based, in large measure, on the financial resources of the grant applicant and the particular needs of the community that would be serviced by the new facility.

Although both direct spending and tax expenditure pollution programs provide incentives to comply with existing law, these programs fail to provide incentives to reduce pollution below legally allowable levels. These programs lessen the burden of compliance but do not necessarily reduce the pollution level below that which would occur through regulation alone.

Legislative Initiatives

The Carter Administration proposed and the House has just approved extending the full investment tax credit (currently 10 percent) to pollution control equipment amortized over 5 years. Polluters who elect rapid amortization are now limited to only half the investment tax credit for eligible equipment. This change would reduce the cost of capital expenditures necessary to bring many existing plants into compliance with environmental standards and would result in revenue losses of between $100 and $140 million annually.

Immediate expensing of expenditures for pollution control equipment on existing plants also has been discussed. A tax expenditure of this type would result in revenue losses approximately $500 million a year greater than present tax treatment. The Administration has also proposed repeal of the provision excluding the interest on pollution control industrial development bonds from tax.

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[3] For an explanation of why this is so and a more detailed analysis of the efficiency of tax-exempt bonds in general, see the discussion of general purpose fiscal assistance tax expenditures and related spending programs on pages 347–358 of Part 11 of this compendium.

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AGRICULTURE

Tax Expenditures

Agriculture tax expenditures increase the profitability of farming activities, encourage water and soil conservation, and promote the organization of cooperative agricultural business organizations. The major agriculture tax expenditures are the use of cash rather than accrual accounting procedures, the deferral of taxes by expensing certain agricultural and conservation capital outlays, the capital gains treatment of certain types of farm income, and the deductibility of noncash patronage dividends of agricultural cooperatives. Revenue losses from agriculture tax expenditures are expected to be $1.3 billion in fiscal year 1979, as compared to estimated outlays of approximately $7.4 billion for the major domestic agriculture spending programs. Tax expenditures associated with agriculture are described and analyzed in greater detail on pages 51–57 in Part I of this compendium.

Spending Programs

Federal outlays for agriculture primarily support the farm income stabilization programs administered by the Commodity Credit Corporation. The Federal Government also operates numerous agriculture research and service programs intended to improve agricultural technology and production and provide farmers with information on productivity techniques, animal and plant disease control, and other related issues. In addition, funds for soil and water conservation projects are provided to the Department of Agriculture under Federal natural resource and environment programs. Outlays for the major agriculture spending programs are listed in the following table.

Estimated Outlays for Agriculture

[In millions of dollars]

Program	1978	1979	1980
Farm income stabilization [1]	7, 669	5, 381	6, 192
Agriculture research and services	1, 150	1, 225	1, 325
Soil and water conservation [2]	782	798	860
Total	9, 601	7, 404	8, 377

[1] Estimate does not include outlays for Small Business Administration emergency agriculture loans.
[2] Department of Agriculture outlays for conservation, excluding forestry component.

FARM INCOME STABILIZATION

Farm income stabilization has been the central component of Federal agriculture policy since the mid-1930's. The tendency of the American agriculture sector to produce farm commodities in quantities

exceeding domestic demand and the highly cyclical and decentralized nature of agriculture markets have resulted in Federal price support and production control programs to guarantee farmers adequate farm income and agricultural price stability. Wheat, cotton, dairy products, feed grains, peanuts, rice, rye, soybeans, sugar, and tobacco are all currently included under one or more of the Department of Agriculture's income stabilization programs. Livestock, fruits, vegetables, and other crops are not covered in any significant way.

The two major farm income stabilization programs are the commodity price support and deficiency payment programs.

Commodity Price Supports

Price support programs, the primary vehicle of farm income stabilization policy during the 1950's and 1960's, are operated as either purchase programs or loan programs. Under direct purchase programs, the Government agrees to buy unlimited quantities of a specified eligible commodity at a predetermined "support price." Under the loan programs, farmers may receive a Commodity Credit Corporation loan payment using the crop as collateral. The size of the loan is equal to the value of the crop at the established "loan rate." At any point up to the time of loan maturity, farmers may reclaim their crop by repaying the loan plus interest. Alternatively, farmers may forfeit their crop and retain the loan payment. When commodity market prices fall to or below the established loan rates, farmers will generally forfeit their crop and retain the loan payment. Market prices that exceed loan rates will generally induce farmers to repay the loan and retain crops for sale on the open market.

Thus, under both purchase programs and loan programs, farmers are, in effect, guaranteed a minimum "support price" for the commodities listed above on this page regardless of market conditions. Price support levels for some commodities are legislatively determined, while levels for certain other crops need only be "fair and reasonable," as determined by the Secretary of Agriculture.

Deficiency Payments

The 1973 Agriculture Act established "deficiency payment" programs for wheat, feed grains, and cotton; rice was included under such a program in 1975. Deficiency payment programs establish a "target price" for each specified commodity. When the market price for a commodity falls below the established target price, direct deficiency payments are made to producers equal to the difference between the national average market and target prices multiplied by the farmer's expected production on an eligible number of acres. The maximum deficiency payment per farmer for wheat, feed grains, and cotton is $40,000 in 1978 and $45,000 in 1979, with rice payments limited to $52,250 in 1978 and $50,000 in 1979.

Interaction of Price Support and Deficiency Payment Programs

The deficiency payment and price support programs work in tandem for commodities eligible under the deficiency payment programs. If the market price for a commodity would have been below

the loan rate in the absence of the price support program, farmers effectively receive a subsidy equal to the difference between the loan rate and the market price. If the market price is above the loan rate but below the target price, the loan program is inactive as an income support program, and the deficiency payment to a farmer is the difference between the target and the market prices multiplied by the portion of the crop eligible for payments. If the market price exceeds the target price, no subsidy is paid to farmers.

Farmers who participate in Government price support and deficiency payment programs are generally required to comply with Federal agriculture production control programs. These programs are necessary to help stabilize total production levels and prevent the undesired accumulation of excessive Government agriculture stocks. The 1977 Food and Agriculture Act limits the portion of a farmer's crop eligible for deficiency payments to a percentage reflecting the estimated acreage needed to satisfy domestic and export demands at forecast prices plus desired adjustments in stocks. In addition, when agriculture supplies are estimated to be in excessive surplus, the Secretary of Agriculture may implement "set-aside" programs, which require farmers to let a certain pre-determined portion of their acreage lie idle, to be used only for approved conservation purposes.

Crop Insurance and Disaster Relief

In addition to price support and deficiency payment programs, a significant component of farm income stabilization policy in recent years has been the Federal Government's crop insurance and disaster relief programs. The disaster payment provisions of the 1973 Agriculture Act and the 1975 Rice Act authorize cash payments to eligible wheat, feed grain, cotton, and rice producers if they are prevented from planting or if crop yields are below specified levels. In addition, the Federal Crop Insurance Corporation provides all-risk crop insurance to farmers in selected counties for selected crops to cover variable production costs. Insurance premiums under this program are set high enough to cover payment outlays, while administrative costs are financed by appropriations. Farmers are also eligible for substantial Federal credit assistance in the event of financial loss resulting from crop disasters and adverse weather conditions. Emergency agriculture loans are currently provided by the agriculture credit insurance fund of the Farmers Home Administration and by the Small Business Administration. Approximately $6 billion in emergency agriculture loans will be provided to farmers in fiscal year 1978, with $5 billion in loans expected for fiscal years 1979 and 1980.[1]

AGRICULTURE RESEARCH AND SERVICES

The Department of Agriculture supports numerous research and service programs intended to increase the overall productive capacity of the agriculture sector by providing farmers with the most sophisticated research and technical information available. The majority of the spending in this area supports basic agricultural research carried

[1] Although these crop insurance and disaster relief programs will result in substantial outlays and new loans in fiscal year 1979, they will not be considered a central component of farm income stabilization policy for the purpose of the following comparative discussion. The amount of loans, direct payments, and insurance paid out in any given year under these programs is primarily a function of local weather conditions and is only marginally related to national agriculture market conditions.

out in part through land grant universities, State experiment stations, and competitive grants and contracts with non-Federal organizations. In addition, animal and plant health services that aid farmers in the prevention of plant and animal diseases are supported. Agriculture research and services account for approximately 14 percent of total outlays for agriculture.

SOIL AND WATER CONSERVATION

Soil and water conservation is encouraged through direct payment programs to farmers and by actions of Federal agencies, mainly the Soil Conservation Service and the Agricultural Stabilization and Conservation Service of the Department of Agriculture. Direct payments for water and soil conservation projects under the agricultural conservation program (ACP) are made to participating farmers on a cost-sharing basis, with the rate of Federal sharing ranging up to 90 percent of the cost of the project. ACP payments for projects of individual farmers are subject to a $2,500 maximum. For multi-farmer projects, the maximum payment per participant is $10,000. The Federal Government also engages directly in conservation activities, such as watershed preservation.

Relationships Between the Tax Expenditures and Spending Programs [2]

Rationale

Farm income stabilization programs are specifically designed to provide an adequate source of income to farmers in periods of surplus production—either by guaranteeing a minimum price for their commodities, by direct cash payments, or both. In addition, farm income stabilization policy is intended to provide some degree of centralized agricultural planning and price stabilization through production controls and price floors as well as to create domestic and international surplus storage programs.[3]

The intent of the agriculture tax expenditures is less clear and relatively unrelated to the goal of income stabilization. The special rules with respect to agriculture development costs and cash accounting were established by administrative regulations very early in the development of the income tax law and apparently were adopted to simplify recordkeeping for farmers. The capital gains treatment of certain farm income is in part a result of the ambiguous nature of certain farm assets that are used both for business production and held for sale. Neither of these two tax expenditures was formulated primarily to provide farmers with Federal income subsidies.

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[2] The primary emphasis of this section will be on the comparison between agriculture tax expenditures and direct spending programs for farm income stabilization and conservation. Tax expenditures analogous to agriculture research and service outlays are provided in part through the general tax expenditure allowing corporations to expense currently research and development costs (including agricultural research and development). However, a comparison between these two types of Federal aid is not included in this discussion, as these programs are not among the principal elements of Federal agriculture policy.

Similarly, the tax expenditure aiding agriculture cooperatives is not discussed in this section. The preferential treatment for these organizations rests as much or more on the general treatment of cooperative business organizations under Federal tax law as it does on efforts to specifically encourage the development of agricultural cooperatives. Moreover, other than the Farmers Cooperative Service, which costs $3 million annually to operate, and banks for cooperatives, which are Government sponsored, privately owned corporations that incur no public debt, no significant spending programs provide assistance limited to agricultural cooperatives.

[3] The 1977 Food and Agriculture Act provided for the implementation of a producer-held storage program for wheat and other feed grains. These reserves would be released when prices reach a specified "trigger level," helping stabilize price levels and agriculture markets in general.

The soil and water conservation programs of the Department of Agriculture provide financial assistance to farmers for water and soil conservation projects. Similarly, the rules permitting current tax deductions for soil and water conservation, land clearing, and fertilizer costs were added to the Internal Revenue Code between 1954 and 1962 to encourage conservation practices.

Distribution of Benefits

Farm tax expenditure benefits are concentrated among upper income taxpayers. Over three-quarters of the benefits of cash accounting and the expensing of certain farm capital outlays went to individual farmers with expanded gross income [4] over $20,000 in fiscal year 1977. Farmers with expanded income exceeding $30,000 received nearly 60 percent of the total tax expenditure benefits.

The benefits of the capital gains treatment of certain farm income are even more concentrated among high-income taxpayers. Just under one-half of the benefits of this tax expenditure went to individuals with expanded income exceeding $100,000, while farmers with expanded income below $30,000 received only 17 percent of the total benefits.

The amount of agriculture tax expenditures that accrue to corporate farms has been limited by the Tax Reform Act of 1976. In general, only family-owned and small corporate farms (under $1 million in gross receipts) may now use the cash method of accounting and deduct preproductive period expenses of growing or raising crops or animals for tax purposes. In fiscal year 1979, approximately 14 percent of the benefits of this tax expenditure is expected to accrue to corporations, while only 3 percent of the benefits resulting from the capital gains treatment of certain farm income is expected to go to corporate farmers.

The distribution of direct spending agriculture benefits across farmer income classes is more difficult to determine than that of the tax expenditures. The only available direct spending data show the distribution of deficiency payments by size of farm rather than by farmer income class. These data are generally not an accurate measure of the distribution of direct spending agriculture benefits because they do not include the indirect value to farmers of price support programs. Moreover, size of farm is generally a poor indicator of farmer income class, since a great many smaller farmers receive the majority of their income from nonfarm activities.

In general, large farms receive the bulk of total price support and deficiency payments, as they are responsible for the majority of commodity sales. Moreover, because target prices and price support levels are based in large measure on the average per unit cost of farm products, large, more efficient farms with relatively low per unit costs generally receive proportionally greater benefits per commodity unit than smaller, less efficient farms.

Direct Government farm payments generally comprise a larger share of net farm income the greater the size of the farm. This is in part due to the larger share of nonfarm income in total income for smaller farms. Government payments accounted for an average of

[4] Expanded income is a broader income concept than that of adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

approximately 21 percent of the net income of farms with gross annual receipts exceeding $20,000 in 1968, but only about 10 percent, on average, of the net income of farms with receipts less than $20,000. In 1973, Government payments accounted for an average of about 7 percent of the net income of farms with gross receipts exceeding $20,000 but only 4 percent of the net income of farms with net receipts below $20,000.[5]

In contrast to some of the tax expenditures, agriculture spending program payments are not restricted by statute to family-owned or small corporations, or to individual farmers. However, ceilings that restrict the amount of deficiency payments paid to producers do limit, to some degree, the magnitude of direct spending payments accruing to very large corporate as well as noncorporate farms. The 1977 Food and Agriculture Act required a study on the probable effects of limiting direct spending farm payments to noncorporate farmers.

Magnitude of Benefits

Because agriculture tax expenditures are either deductions or deferrals of taxable income, their value is determined by the producer's marginal tax bracket. The value to the individual farmer of currently deducting agricultural capital expenses or of receiving capital gains treatment on farm income increases the higher the farmer's taxable income and associated marginal tax bracket. Farmers without taxable income and tax liability (apart from the tax expenditures themselves) receive no benefits from agriculture tax expenditures.

Agriculture spending program payments, in general, provide larger benefits to larger scale farming operations. However, in contrast to the tax expenditures, payments are decreased in value the higher a farmer's income class. Since deficiency payments, indirect subsidies from Federal price support programs, and agriculture conservation program payments are included in taxable income, their after-tax value is reduced the larger a farmer's taxable income since a larger percentage of the given payment is returned to the Government in taxes. A $100 direct deficiency or soil conservation payment is worth $40 to a farmer in the 60 percent income tax bracket, yet is worth $85 to a farmer in the 15 percent bracket; a comparable $100 deduction or deferral associated with an agriculture tax expenditure is worth $60 to a farmer in the 60 percent bracket but only $15 to a farmer in the 15 percent bracket.

Low-income farmers are generally provided increased cost-sharing subsidies under the agricultural conservation program for qualified water and soil conservation projects. By contrast, low-income farmers without tax liability are ineligible for the tax expenditures associated with soil and water conservation, land clearing expenses, fertilizer costs, and other conservation expenses.

There are no statutory limits on the amount of aid a farmer may receive under agriculture tax expenditures. The size of direct deficiency and conservation payments, in contrast, is subject to statutory ceilings. Moreover, farmers participating in direct income stabilization programs are generally subject to agricultural production controls and other regulations which limit the amount of crops eligible for

[5] U.S. Department of Agriculture data, cited in Robert Crandall, "Federal Government Institutions To Reduce the Price Level," paper presented at The Brookings Institution Panel on Economic Activity, April 20–21, 1978, p. 21.

program payments. These production controls may, however, somewhat reduce the tax expenditures associated with cash accounting and the expensing of agriculture capital outlays by limiting the amount of capital and inventory expenses.

Scope of Benefits

The benefits produced by the expensing of certain farm capital outlays and the use of cash accounting procedures are available to producers of a wider range of commodities than are farm income stabilization payments or capital gains benefits for certain farm income. Cash accounting tax provisions are used by row-crop farmers and ranchers to currently deduct the costs of seed, feed grains, and other supplies that normally would be considered part of inventory costs and deducted in later years under accrual accounting methods. Tree crop and vineyard farmers as well as owners of cattle and other livestock raised for breeding and dairy purposes receive significant tax expenditure benefits by currently deducting many of the developmental capital expenses associated with raising or growing these assets, which in nonfarm industries are generally treated as capital expenditures and are depreciated over their useful lives.

Benefits from the capital gains agriculture tax expenditure and from spending programs are more concentrated in particular commodity sectors than are the benefits of cash accounting and the expensing of certain capital costs. Capital gains treatment for farm income is concentrated among farmers who sell orchards, vineyards, and livestock held for breeding, dairy, and sporting purposes.[6] Deficiency payments and price support programs primarily subsidize row crops such as wheat, feed grains, rice, and cotton and do not affect fruit and vegetable growers, dairy producers, or ranchers.

Relation of Program Levels to Agriculture Market Conditions

The levels at which agriculture spending programs operate depend on general commodity market conditions in a given harvest season. Program spending increases during periods of agricultural surplus when market prices fall below target prices and/or loan rates and farm income is low. Outlays decrease in periods of strong agricultural demand and relatively short supply when market prices exceed target prices and farm income is relatively high.

Agriculture tax expenditures, in contrast, either increase in times of agricultural prosperity and relatively high farm income—producing a procyclical economic effect—or are relatively unrelated to agriculture market conditions and anticipated farm income. The benefits of cash accounting and the expensing of capital and development costs depend, for example, on the costs of planting crops for the succeeding year's harvest, the costs incurred in planting vineyards and fruit orchards, and on the timing of tax deductions. The more producers spend on eligible inventories and developmental supplies, the greater is the Federal tax expenditure program, regardless of the anticipated price of the commodities being produced. The magnitude of the tax

[6] Eligible commodities must be held for specified periods of time before they can receive capital gains treatment.

expenditures resulting from the capital gains treatment of certain farm income depends on the price and volume of the products sold and the timing of sales. For example, income from the sale of livestock, which accounts for a significant percentage of farm income subject to capital gains treatment, generally increases in times of low prices because breeder farmers tend to liquidate their herds. Thus, in this case, the tax expenditures increase in low-price markets. In other cases, income subject to capital gains may increase when market prices are high.

Administration

Price support, deficiency payment, and production control and storage programs are coordinated by the Secretary of Agriculture to reflect expected world food production, domestic production capabilities, domestic and international storage supplies and demand, and anticipated weather and crop conditions. Loan rates and target prices are established on the basis of market conditions to provide farmers a minimum "fair" return on the production and sale of farm commodities. These rates and prices are periodically adjusted to compensate for short-run changes in commodity markets, either by specified formulas based on prices and expected production or, in many cases, simply at the discretion of the Secretary of Agriculture subject to maximum and minimum limits.

Tax expenditures, on the other hand, are not "administered" in the same sense as agriculture spending programs, and they cannot be regulated by administrative agencies in anticipation or reaction to short-term commodity market conditions.

General Economic Effects

Lower farm taxes that result from the expensing of certain farm capital outlays, the use of cash accounting, and the capital gains treatment of certain farm income reduce the cost of agricultural production and may, therefore, result in lower food prices. Similarly, deficiency payments increase farm income without directly increasing commodity prices in the short run. Price supports, on the other hand, directly affect the selling price of eligible commodities since they guarantee, in effect, that market prices will not fall below price support levels. As a result, price supports tend to be inflationary compared to both deficiency payments and the agriculture tax expenditures because they place a direct cost on consumers in the form of higher prices.

Tax expenditure and spending programs, by increasing the economic return on agricultural production and investment above what it would be in the absence of Federal subsidies, may result in less than optimal production levels in some commodity sectors. One recent study suggested, for example, that tax expenditures may have contributed to unstable price conditions in the cattle market in recent years.[7] Another study suggested that orchard, grove, and vineyard farmers may have received lower crop income as a result of overinvestment induced in part by agriculture tax expenditures.[8] Some poultry industry representatives have indicated in recent years that the use of

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[7] Rhodes, "Consequences of Income Tax Law and Regulations: Cattle Feeding," in *Income Tax Rules and Agriculture*, Special Report No. 172, University of Missouri—Columbia, Agriculture Experiment Station, December 1974, pp. 28, 31.

[8] Carman, "Consequences of Income Tax Law and Regulations: Orchard Development," in *Income Tax Rules and Agriculture*, op. cit., pp. 34–35.

cash rather than accrual accounting permitted under current tax provisions has been a significant factor contributing to the highly cyclical market for poultry products.

Deficiency payment and price support programs may have contributed to overproduction in many major commodity markets. Long-run grain production would undoubtedly fall in the absence of such programs as a result of reduced profit margins. However, many experts believe that surplus production of certain grain commodities may be advantageous in terms of foreign trade and grain reserve policies.

Overlap of Benefits

Row crop farmers receive overlapping tax and direct spending agriculture assistance from price support and deficiency payment programs and from the tax expenditure allowing the use of cash rather then accrual accounting. In general, however, tax expenditures and spending programs are targeted to different types of producers, with a relatively small amount of overlapping benefits. Direct spending agriculture programs are primarily targeted to producers of wheat, cotton, rice, feed grains, and other row crops, and do not affect producers of fruit, vegetables, and livestock. In contrast, agriculture tax expenditures provide relatively greater benefits to those producers not covered under direct spending programs.

Livestock owners, orchard farmers, and vineyard farmers, in particular, receive substantial tax benefits from both the major agriculture tax expenditures. Capital gains treatment is generally available for the sale of orchards, vineyards, and livestock used for breeding, draft, sporting, and dairy purposes when, at the same time, these assets may have been developed or improved by expenditures which were deducted under the expensing of farm capital outlays tax expenditure. In addition, the value of deferring tax on development costs is increased for owners of orchards, vineyards, and livestock as a result of the relatively long development period for these commodities as compared to row crops.

Legislative Initiatives

President Carter's 1978 tax program recommended that all large farming corporations and farm syndicates [9] be required to use accrual rather than cash accounting for production and development expenses. Under the 1976 Tax Reform Act, certain family-owned corporations were exempted from the accrual requirement, as were corporations with gross annual receipts of less than $1 million. The Administration believes that the family farm exemption results in an inequitable subsidy for large, family-owned corporate farms relative to other corporate farms of equal size, and should therefore be eliminated; the exemption for small farms would remain. In addition, all farm syndicates would be required to use the accrual accounting method. Currently, farm syndicates may deduct the cost of feed, seed, fertilizer, and certain other production supplies when these supplies are used.

The Administration's recommendations would further reduce the use of farm syndicates for tax shelter purposes and, it is argued, would result in more accurate taxation of farm operations on the basis of actual annual income.

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[9] A farming syndicate is generally a partnership or other enterprise organized expressly for investment purposes, and which includes significant numbers of limited partners or other persons not actively participating in the management of the farming enterprise.

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HOMEOWNERSHIP

Tax Expenditures

Tax expenditures are the primary source of Federal financial support for homeownership for a large segment of middle and upper income taxpayers. The principal tax expenditures that foster homeownership are the deductions for home mortgage interest and property taxes, the deferral of capital gains on certain home sales, and the excess bad debt deduction allowed savings and loan associations and mutual savings banks which provide the major sources of mortgage financing to homeowners.[1] These tax expenditures will result in revenue losses of approximately $12.5 billion in fiscal year 1979. Homeownership tax expenditures are discussed in greater detail on pages 67–70 and 87–88 in Part I of this compendium.

Spending Programs

The Federal Government provides financial assistance to homeowners through a variety of interest subsidy, direct loan, insurance, and guarantee programs. Outlays for the major programs that foster homeownership are listed in the following table.

[1] The exclusion from taxable income of the imputed rental value of owner-occupied housing is a major tax incentive fostering homeownership. Although conceptually a major departure from the concept of taxable income (resulting in personal income tax revenue losses of about $3.0 billion in fiscal year 1977), the exclusion is not classified as a tax expenditure since, in practice, imputed rent calculations are difficult to make, and because imputed rent resembles a nontaxable, in-kind benefit not generally classified as a tax expenditure.

Estimated Outlays for Homeownership [1]

[In millions of dollars]

Program	1978	1979	1980
Section 235 homeownership assistance	125	140	240
FHA loans and guarantees [2]	585	261	261
VA loans and guarantees	−21	−46	−9
Rural housing insurance fund [2]	397	544	587
GNMA assistance [3]	−8	13	16
Section 312 rehabilitation loans	43	56	55
Total	1, 121	968	1, 150

[1] Gross annual credit activity is in many ways a better measure than outlays of the Federal homeownership assistance provided by loan, guarantee, and insurance programs. Gross credit activity reflects the sum of all loans obligated during a fiscal year under direct loan programs and the value of all commercial loans insured under mortgage guarantee programs. Outlays, on the other hand, reflect only administrative costs and net lending activity—interest subsidies, loan defaults, new loans, and repayments on prior-year loans. As such, outlay figures are highly influenced by prior-year lending activity and mortgage market conditions and, therefore, do not accurately reflect a program's annual credit market activity. Indeed, some programs that have great influence on the availability of homeownership financing show negative outlay costs in years when prior-year loan repayments, interest, and fees exceed the amount of total outlays necessary to cover new loans and guarantee payments. The gross annual credit activity for the major homeownership loan and guarantee programs is listed in the following table:

[In millions of dollars]

Program	Credit activity		
	1978	1979	1980
FHA loans and guarantees [1]	8, 843	12, 571	(2)
VA loans and guarantees [3]	14, 610	14, 933	15, 070
Rural housing insurance fund [4]	2, 690	2, 705	(2)
GNMA programs [5]	-----	137	(2)
Section 312 rehabilitation loans [6]	80	275	(2)

[1] Mortgages insured. HUD Office of Housing estimate.
[2] Unavailable.
[3] Principal amount of loans guaranteed plus direct loans. VA generally guarantees only a portion of principal mortgage value. These figures, however, reflect the full amount of mortgages and so exaggerate VA's liability to some degree. VA estimates.
[4] New loan obligations, both direct and insured, all FmHA single-family programs. FmHA Budget Division estimates.
[5] New mortgages under both special assistance and emergency mortgage purchase programs, single-family housing. GNMA estimates.
[6] Total new loans. HUD Office of Urban Rehabilitation and Community Reinvestment estimates.

[2] Includes single-family homeownership only.
[3] Includes single-family homeownership portion of special assistance fund and emergency mortgage purchase program.

SECTION 235 HOMEOWNERSHIP ASSISTANCE

The Department of Housing and Urban Development (HUD) section 235 homeownership program provides mortgage subsidies for low-income families that reduce effective interest rates to as low as 4 percent. Families with adjusted gross income of up to 95 percent of the

median income in the relevant area are eligible. Homeowners must contribute at least 20 percent of their adjusted gross income toward monthly mortgage, insurance, and tax payments, with HUD paying the mortgage lender the difference between the borrower's contribution and the market rate. HUD estimates that about 38,000 families will be receiving assistance under this program by the end of fiscal year 1979, with an additional 257,000 families receiving payments under an earlier version of the program. The single-family mortgage limit is $32,000 ($44,000 for large families in high-cost areas), and the sale price for homes purchased under this program may be 20 percent higher than the mortgage limit.

FEDERAL HOUSING ADMINISTRATION LOANS AND GUARANTEES

The Federal Housing Administration (FHA) provides home mortgage insurance under a variety of programs. These insurance programs increase the general availability of mortgage credit and permit more liberal interest and downpayment terms by covering over 95 percent of a lender's potential losses in case of default. There are no income limits for participation in the program, although borrowers must demonstrate that their income is adequate to meet the mortgage payments. The maximum mortgage for a single-family home eligible for insurance under this program is presently $60,000. HUD expects 685,000 applications for home mortgage insurance in fiscal year 1979.

VETERANS ADMINISTRATION LOANS AND GUARANTEES

The Veterans Administration (VA) provides insured, guaranteed, and direct homeowner loans to eligible veterans, making possible somewhat lower than market mortgage interest rates and downpayments. There are no income eligibility limits or maximum mortgage amounts under this program, although direct loans may not exceed $33,000 ($35,000 in high-cost areas). The VA expects to assist 375,000 veterans with mortgage loans in fiscal year 1979.

RURAL HOUSING INSURANCE FUND

The Farmers Home Administration (FmHA) in the Department of Agriculture provides housing assistance in credit-short rural areas through its rural housing insurance fund. The fund is a largely self-financing revolving source of loan money, with annual Congressional appropriations to cover net losses resulting from below-market interest subsidies provided eligible borrowers. The basic homeownership program, section 502, provides loans to low- and moderate-income borrowers in rural areas who cannot obtain reasonable credit terms elsewhere. Low-income borrowers (below $10,000 in most areas) are eligible for interest subsidies that reduce interest rates to as low as 1 percent, while moderate-income borrowers (below $15,600 in most areas) pay interest rates somewhat below market rates. There are no statutory maximum mortgage limits, although housing is supposed to be "modest." FmHA expects to provide assistance for about 165,000 rural housing units in fiscal year 1979 under this program.

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GNMA ASSISTANCE

The Government National Mortgage Association (GNMA) is a corporation within the Department of Housing and Urban Development which purchases FHA, VA, and conventional mortgages under a variety of programs. Under its so-called "tandem plan," GNMA provides an interest subsidy which permits lenders to offer mortgages at a below-market 7½-percent interest rate. GNMA purchases these low-interest mortgages from lenders at the market rate, absorbing the difference between 7½ percent and the market rate. While GNMA has authority to purchase both single- and multi-family mortgages, new commitments recently have been concentrated almost entirely on multi-family mortgages. There are no income limits for borrowers, although the maximum mortgage amount (with some exceptions) is $42,000 per unit. The primary purpose of the tandem plan is to stabilize housing production and smooth out cyclical fluctuations in secondary mortgage markets, rather than to make housing available to families who could not otherwise afford it. GNMA administrators expect no new single-family commitments in fiscal 1978 or 1979, although assistance may become available for single-family homes in the future. GNMA supported 64,800 single-family units in fiscal year 1977.

SECTION 312 REHABILITATION LOANS

The HUD section 312 program provides 3-percent loans to property owners in urban renewal and other economically depressed areas to enable them to finance rehabilitation needed to bring property up to housing code standards. While there are no income limits for the program, priority is given to low- and moderate-income families. The maximum loan amount for single-family homes is $27,000. HUD estimates that 10,000 loans supporting 15,000 housing units will be made in fiscal 1979.

Relationships Between the Tax Expenditures and Spending Programs

Distribution of Benefits

The bulk of all tax and direct Federal assistance for homeownership goes to middle and upper income homeowners.[2] This is primarily due to the high cost of housing which requires substantial investments on the part of purchasers even with tax and direct spending assistance. These investments generally can be made only by middle and upper income individuals. However, direct spending programs provide proportionally greater benefits to middle-income homeowners, while tax expenditures provide greater aid to those in higher income brackets.

The HUD section 235 interest subsidy program primarily benefits middle-income homeowners in the $10,000 to $20,000 range; the

[2] The only exception is the FmHA rural housing program, which provides significant benefits to low- and moderate-income homeowners. The different distribution of aid under this program is primarily the result of increased targeting efforts, although the generally lower overall standard of living in rural areas also significantly affects the distribution of aid among income classes relative to other Federal homeownership spending programs.

FHA and VA credit programs offer slightly more benefits to those in higher income brackets. Over half of the GNMA tandem program benefits go to homeowners with incomes exceeding $20,000.

The following table summarizes the information that is available with respect to the distribution of benefits by income class for homeownership spending programs.

Percentage Distribution of Homeownership Spending Program Benefits by Income Class [1]

Income class [2] (thousands)	Programs				
	Sec. 235 [3]	FHA credit [4]	Rural housing [5]	GNMA tandem [6]	Sec. 312 [7]
0 to $10	19	6	50	1	35
$10 to $20	80	67	35	46	47
$20 to $50	1	27	15	51	17
$50 and over	0	0	0	2	1

[1] Distributions are unavailable for VA credit programs.
[2] The distributions are based on slightly differing definitions of income for each spending program, since each administering agency uses its own particular definition of income in compiling program data. Nevertheless, because they vary only slightly, the table does illustrate the relative general distributions of these spending program benefits by income class.
[3] 3d quarter, 1977.
[4] Sec. 203, the primary FHA homeownership mortgage credit program, calendar year 1976.
[5] Sec. 502, the major FmHA homeownership program, fiscal year 1974.
[6] Conventional single-family mortgages purchased by GNMA, 1st half of calendar year 1976. Distribution of FHA and VA mortgages purchased by GNMA would show a greater concentration of benefits in the lower income classes.
[7] Calendar year 1977.

Sources: Department of Housing and Urban Development and the Farmers Home Administration, Department of Agriculture.

In contrast to the spending programs, nearly three-fourths of the tax expenditures that directly aid individual homeowners went to taxpayers with expanded gross income [3] over $20,000 in fiscal year 1977. This distribution results in part because property tax and mortgage interest tax expenditures are available only to taxpayers who itemize personal deductions. Recent sharp increases in the standard deduction have, therefore, concentrated homeownership tax expenditure benefits among the higher income classes, while precluding a substantial number of homeowners with annual income below $20,000 from receiving any tax expenditure aid.

Benefits from the deferral of capital gains on home sales are distributed more equally among middle and upper income taxpayers than are those from the two other homeownership tax expenditures. Since taxpayers need not itemize to take advantage of this tax provision, a significant number of persons in the $10,000 to $20,000 income class, who receive no benefits from the other homeownership tax expenditures because they use the standard deduction, receive homeownership capital gains benefits.

[3] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

The distribution of homeownership tax expenditures by income class is shown in the following table:

Percentage Distribution of Homeownership Tax Expenditures by Income Class, Fiscal Year 1977

Expanded income class [1] (thousands)	Mortgage interest deduction [2]	Property tax deduction [2]	Deferral of capital gains tax
0 to $10	2.0	1.9	4.0
$10 to $20	24.5	19.4	42.8
$20 to $50	61.2	53.0	48.3
$50 and over	12.3	25.7	4.8

[1] Significant differences in the distribution of tax expenditures resulting from the use of expanded income (see footnote 3 to text, p. 251) rather than the narrower income definitions used in the table on p. 251 exist for the most part only with respect to individuals with incomes in excess of $50,000. Taxpayers with incomes below $50,000 generally do not have significant amounts of tax preference income.

[2] The percentage of these benefits accruing to higher income taxpayers is expected to increase in calendar year 1978 as a result of the increased standard deduction enacted in the Tax Reduction and Simplification Act of 1977.

Source: Department of the Treasury.

Since homeownership tax expenditures take the form of deductions and exclusions, taxpayers receive a greater subsidy for each dollar excluded or deducted from taxable income as their income and marginal tax bracket increase. A married couple filing jointly with taxable income of $75,000 saves $55 in Federal taxes by deducting $100 in property taxes and mortgage interest, while a married couple filing jointly with taxable income of $15,000 saves only $22 for an equal $100 deduction.

By comparison, direct Federal spending programs either provide subsidies exclusively to low- and middle-income homeowners on the basis of income eligibility tests, as in the HUD section 235 or FmHA rural housing programs, or offer approximately equal subsidies for all homeowners regardless of income class, as in the FHA and VA loan programs. In contrast to the tax expenditures, no direct Federal housing program systematically increases the magnitude of its subsidy as participant income increases.

Scope of Benefits

Almost twice as many homeowners receive tax expenditure subsidies as receive spending program assistance. Direct spending programs benefit a smaller number of persons for several reasons. First, the demand for mortgage guarantee and insurance services is limited, since persons who are able to secure loans without insurance or guarantees or who can obtain these services in the private sector at a lower cost have no need of Government assistance. In addition, persons buying relatively expensive homes usually do not use such assistance because of the ceilings on the size of the mortgages which can be guaranteed or insured under the various programs.

Furthermore, several direct homeownership subsidy programs are restricted by family income eligibility requirements. Others are limited

by the level of appropriated funds. The latter restriction affects the HUD section 235 and the FmHA section 502 programs, where appropriated funds are not sufficient to cover all those nominally eligible for assistance.

In contrast, the major homeownership tax expenditure subsidies are available to everyone who owns a home and itemizes deductions. In calendar year 1977, an estimated 19.2 million families received benefits from the two major homeownership tax expenditures compared to an estimated 9.7 million families who received some form of direct spending program assistance.[4]

Type of Housing Subsidized

With the exception of VA loans, guarantees, and insurance, all Federal homeownership spending programs are restricted to "moderate" or "modest" types of housing, usually defined by specific mortgage limits. Section 235 subsidies, FHA mortgage insurance, and GNMA tandem assistance programs all have statutory limits on the size of eligible mortgages, while FmHA assistance is required to go to "modest" housing. Section 312 rehabilitation loans are intended to revitalize existing housing, generally in economically depressed urban areas.

Tax expenditures, on the other hand, provide homeownership assistance for any type of housing, regardless of its cost. Indeed, homeownership tax expenditure benefits are increased with the size and value of the home, since these factors determine in part the magnitude of property tax and mortgage interest payments.

Overlap of Benefits

In a great many cases, homeowners benefit from both tax and direct spending subsidies. Many homeowners receive GNMA tandem assistance and FHA mortgage insurance as well as tax deductions for home mortgage interest and property taxes.

Federal support for homeownership through the combination of tax expenditures and FHA and VA mortgage insurance was the primary factor responsible for the rapid growth of homeownership between 1940 and 1970. During that time, the percentage of owner-occupied housing in the United States rose from 43 to 63 percent. According to a study by Dr. George Peterson of the Urban Institute,[5] approximately half of this increase in homeownership in the middle-income levels was due to FHA and VA mortgage insurance programs and half to homeownership tax expenditures. At higher income levels a greater share of the increase was attributable to homeownership tax expenditures, while at the lower income levels almost all the increase was due to mortgage insurance.

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[4] Beneficiary estimates are based on the number of outstanding direct, insured, and guaranteed loans on December 31, 1977, under all HUD, FHA, VA, and FmHA single-family homeownership assistance programs, and on Treasury Department extimates of the number of tax returns claiming at least one of the two major homeownership tax expenditures for calendar year 1977. Direct spending data provided by the Management Information Systems staff of the Farmers Home Administration, the Single-Family Insurance Branch of the Federal Housing Administration, and the Loan Guarantee Service of the Veterans Administration.

[5] George E. Peterson, *Federal Tax Policy and Urban Development* (forthcoming).

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RENTAL HOUSING

Tax Expenditures

Tax expenditures are an integral component of Federal policy affecting the supply and availability of rental housing. When combined with direct Federal assistance programs, tax expenditures create the basic financial incentives for investors, developers, and builders to construct low- and moderate-income rental housing. Moreover, tax expenditures, in conjunction with favorable tax rules applicable to borrowing funds, increase the overall return on investments in rental housing and housing rehabilitation for persons in high marginal tax brackets by generating tax losses which "shelter" other non-real estate income from tax.

The major tax expenditures affecting rental housing construction are accelerated depreciation in excess of straight-line and the expensing of construction period interest and taxes. The accelerated depreciation tax expenditure is expected to result in revenue losses of approximately $360 million in fiscal year 1979, while the expensing of construction period interest and taxes is expected to reduce Federal revenues by approximately $615 million, of which about $90 million is related to rental housing construction.

The 1976 Tax Reform Act phases down for individual taxpayers over the next several years the provisions allowing the expensing of construction period interest and taxes and requires that, in the future, individuals must capitalize and amortize such interest and taxes over specified periods of time. However, these periods still will be substantially shorter than the periods over which other rental housing construction costs can be depreciated.

In addition to the two major rental housing tax expenditures, the rehabilitation of low- and moderate-income rental housing is assisted by a minor tax expenditure allowing the 5-year amortization of related construction expenses. Both new construction and rehabilitation are subsidized by the exclusion from taxable income of interest on bonds issued by State and local housing authorities.[1] Tax expenditures associated with rental housing are discussed in greater detail on pages 73–74, 77–80, and 105–106 in Part I of this compendium.

Spending Programs

The Federal Government provides direct rental housing assistance under a variety of programs ranging from rent subsidies for low-income tenants to low-interest mortgage loans, guarantees, and financing for large-scale public housing projects. Outlays for the major Federal programs intended to expand the supply and availability of rental housing are listed in the following table.

[1] This tax expenditure is part of the broader tax expenditure providing for the exclusion of interest on State and local debt.

Estimated Outlays for Rental Housing [1]

[In millions of dollars]

Program	1978	1979	1980
Low-rent public housing	1, 720	1, 890	2, 010
Sec. 8 lower income housing assistance	876	1, 320	1, 750
Sec. 236 interest subsidy	600	620	670
Rent supplement [2]	280	260	250
GNMA assistance [3]	−217	376	459
FHA loans and guarantees [3]	65	29	29
Rural housing insurance fund [3]	17	44	79
Sec. 202 housing for the elderly or handicapped	320	550	852
Total	3, 661	5, 089	6, 099

[1] Gross annual credit activity is in many ways a better measure than outlays of the rental housing assistance provided by Federal loan, guarantee, and insurance programs. Gross credit activity reflects the sum of all loans obligated during a fiscal year under direct loan programs and the value of all commercial loans insured under mortgage guarantee programs. Outlays, on the other hand, reflect only administrative costs and net lending activity—interest subsidies, loan defaults, new loans, and repayments on prior-year loans. As such, outlay figures are highly influenced by prior-year lending activity and mortgage market conditions and, therefore, do not accurately reflect a program's annual credit market activity. Indeed, some programs that have great influence on the availability of rental housing financing show negative outlay costs in years when prior-year loan repayments, interest, and fees exceed the amount of total outlays necessary to cover new loans and guarantee/insurance payments. The gross annual credit activity for the major rental housing loan and guarantee programs is listed in the table below:

[In millions of dollars]

Program	Credit activity		
	1978	1979	1980
GNMA assistance [1]	1,400	2,200	(3)
FHA loans and guarantees [2]	2,911	3,692	(3)
Rural housing insurance fund [4]	704	906	(3)
Sec. 202 housing for the elderly or handicapped [5]	750	800	(3)

[1] New mortgages purchased. GNMA estimates.
[2] New mortgages insured, all FHA multifamily programs. HUD, Office of Housing estimates.
[3] Unavailable.
[4] New loan obligations, both direct and insured, all FmHA multifamily programs. FmHA Budget Division estimates.
[5] Total new loans. HUD, Office of Housing estimate.

[2] The Administration has requested a fiscal year 1978 $24,000,000 supplemental 1-year appropriation for the rent supplement program not included in these estimates.

[3] Includes rental housing only.

LOW-RENT PUBLIC HOUSING

Public housing has been the predominant form of Federal rental housing assistance for low-income families since it was established in 1937. There are currently almost 3,000 local public housing agencies operating about 1.2 million units with over 3 million tenants. Approximately three-quarters of all public housing units are in metropolitan areas.

Local housing authorities finance the construction of new public housing facilities by issuing 40-year, tax-exempt bonds for which the Department of Housing and Urban Development (HUD) pays both principal and interest. Public housing units, in turn, must be exempt from local real estate taxes.

Although operation and maintenance costs were originally to be financed by tenant rent payments, rent is now limited by law to no more than 25 percent of tenant income, and Federal subsidies are

necessary to cover some of these costs. Public housing is targeted to low-income families, with income eligibility requirements set by local authorities subject to HUD approval. Occupants range from those receiving some form of public income assistance to those with annual income of approximately $5,500. The median tenant income in fiscal 1977 was slightly less than $3,700.

SECTION 8 LOWER INCOME HOUSING ASSISTANCE

Rent subsidies for low- and moderate-income tenants in privately owned housing have become an increasingly important component of Federal rental housing policy in recent years. HUD section 8, established in 1974, is the major program providing housing assistance to low- and moderate-income families living in privately owned housing. Under section 8, HUD, working through local public agencies, makes subsidy payments to owners of rental housing units on behalf of low- and moderate-income tenants with incomes of up to 80 percent of the area median. Tenants pay 15 to 25 percent of their income in rent (depending on household size and income), with HUD supplying the difference between that amount and the rent normally charged for the unit.

Section 8 is aimed at stimulating new rental construction as well as providing subsidies for renters in already existing housing. Under section 8's new construction/substantial rehabilitation component, HUD contracts with builder/developers or public agencies to make rent subsidy payments on behalf of eligible renters for up to 30 years (40 years if the project is financed by State or local housing agencies). Under the existing housing component of section 8, rent subsidy payments are made to owners of existing rental housing on behalf of eligible tenants for up to 15 years.

SECTION 236 AND RENT SUPPLEMENT PROGRAMS

HUD's rent supplement and section 236 programs were the major rental assistance subsidy programs prior to the authorization of section 8. While both programs are currently being phased out in favor of section 8, significant annual outlays continue from prior-year commitments. Under section 236, HUD makes periodic direct subsidy payments to mortgage lenders, who, in turn, reduce interest costs for project sponsors to the equivalent of what they would be on a 1-percent mortgage. These mortgage interest subsidies make possible greatly reduced monthly rental charges, with tenants paying the greater of either the reduced rent or 25 percent of their monthly income. A related "deep subsidy" program authorizes HUD to provide additional subsidy payments for very low-income tenants for up to 20 percent of the units in a project.

The HUD rent supplement program, like section 236, reduces rent payments to 25 percent of tenant income, but does so by direct payments to rental housing owners rather than to mortgage lenders.

GNMA ASSISTANCE

The Government National Mortgage Association (GNMA) is a public corporation within HUD which purchases mortgages under a variety of programs. Under its so-called "tandem plan," GNMA

provides an interest subsidy which permits lenders to offer mortgages at a below-market 7½ percent interest rate. GNMA purchases these low-interest mortgages from lenders at the market rate, thereby absorbing the difference between 7½ percent and the market rate.

Most of GNMA's new mortgage commitments in the last several years have been for multi-family rental housing, although it is also authorized to purchase single-family mortgages. GNMA tandem 7½ percent mortgages are frequently combined with section 8 rent subsidy payments to increase the total subsidy supporting a particular project. GNMA has authority to purchase the mortgages of conventional nonsubsidized projects as well as those that are FHA-insured and Government-subsidized.

FHA LOANS AND GUARANTEES

The Federal Housing Administration (FHA) provides mortgage insurance for multi-family rental housing projects under a variety of programs. The primary programs for new construction and substantial rehabilitation are the section 221(d)(3) market interest rate and the section 221(d)(4) programs, both of which insure mortgages for up to 40 years. Although there are no tenant income limits for either program, section 221(d)(3) is designed to serve families with somewhat lower incomes than families benefited under section 221(d)(4). The per-unit cost ceiling is lower in the section 221(d)(3) program, and the mortgage may cover 100 percent of the project's replacement cost, as compared to 90 percent under the section 221(d)(4) program. In addition, insurance for existing multi-family rental projects is provided under section 223(f).

By insuring lenders against almost all losses in case of default, FHA insurance permits rental housing developers to obtain mortgages at somewhat lower than market interest rates, often with more liberal financing and repayment terms. Lower mortgage costs facilitated under this program may be reflected in lower rents, although there are no legal requirements to this effect.

RURAL HOUSING INSURANCE FUND

The Farmers Home Administration (FmHA) in the Department of Agriculture provides direct loans for rental housing in credit-short rural areas through its rural housing insurance fund. This is a largely self-financing revolving fund, with annual Congressional appropriations to cover net losses that result from below-market interest rates provided to eligible borrowers. Under the section 515 rural rental program, the fund offers loans to rental housing project sponsors at interest rates as low as 1 percent, with project rents set at levels reflecting this subsidy. Tenants must be 62 years of age or older or have low (below $10,000) or moderate (below $15,600) income.

SECTION 202 HOUSING FOR THE ELDERLY OR HANDICAPPED

The HUD section 202 program, established in 1959, originally provided direct Federal loans at 3-percent interest for new construction and rehabilitation of rental housing serving elderly and handicapped persons. The program was targeted to elderly and handicapped persons with incomes above the level set for public housing but below that

needed to pay for adequate private housing. Interest rates on loans under this program were increased in 1974 to the Treasury's average borrowing rate on all debts, plus an allowance to cover administrative costs and probable losses. Since this change would have resulted in rents higher than low- and moderate-income tenants could afford, the 1974 legislation required, in addition, that section 8 rent subsidies be provided in section 202 projects. HUD currently requires that at least 20 percent of the units in section 202 projects be set aside for section 8 subsidies, but, in practice, most section 202 projects have been 100 percent subsidized under section 8.

The section 202 program is limited to nonprofit sponsors, who are required to provide a wide range of special project services including health services, continuing education, welfare, recreation, counseling, referral, and transportation to social services.

Median Income of Housing Program Participants

The following table shows the median income levels of participants in those of the aforementioned rental housing programs for which this information is available.

Median Income Level of Participants in Rental Housing Spending Programs

Program	Median income level
Public housing	$3, 691
Section 8:	
New construction/substantial rehabilitation	4, 376
Existing housing	3, 506
Section 236	6, 285
Rent supplement	3, 544

Source: Department of Housing and Urban Development. Estimates are for participants in September 1977, except for the section 8 estimates, which are for participants in June 1977.

Relationships Between the Tax Expenditures and Spending Programs

Rationale

Federal rental housing policy is intended both to stimulate rental housing construction and to provide rental assistance for low- and moderate-income families and individuals. The existing rental housing component of the section 8 program, for example, deals primarily with household rental assistance, and has little effect on the supply of rental housing other than to maintain some buildings that might otherwise be abandoned. Other programs, such as the tax expenditures allowing accelerated depreciation and the deduction of construction period interest and taxes, principally stimulate the construction of new rental housing, providing little, if any, direct household rental assistance.

The majority of Federal rental housing spending programs, such as public housing, the new construction component of section 8, and

section 236, as well as the GNMA and FHA loan and guarantee programs, provide stimulus to new rental housing construction coupled with various forms of household rental assistance. The relative emphasis on these two policy goals affects the type of housing subsidized (new or already existing), the income class and type of persons who benefit directly (low-income tenants, investors, builders), and the average cost per unit of affected housing. Programs concerned primarily with household assistance generally cost less per unit of rental housing than those that also subsidize construction costs.

Both tax expenditures and spending programs focus heavily on new housing construction rather than already existing or rehabilitated facilities. More than 50 percent of the budget authority for HUD section 8 is allocated for new construction in fiscal year 1978, and there is a similar heavy emphasis on new construction in the public housing program. The rental housing tax expenditure subsidies are focused principally on new construction, except for the relatively small 5-year amortization tax expenditure for rehabilitated housing construction expenses, which will result in estimated revenue losses of $15 million in fiscal year 1978 and $10 million in fiscal year 1979. This emphasis on new construction in both spending and tax expenditure programs may have an adverse impact on the maintenance and rehabilitation of existing housing since both new and existing housing must compete for limited resources and financing.

Distribution of Benefits

The bulk of Federal rental housing spending programs provide direct benefits to low- and moderate-income families and individuals in the form of subsidized, low-rent housing. Public housing, the HUD section 8 and 236 programs, and the rent supplement program all provide housing for low- and moderate-income tenants at rents in most cases no greater than 25 percent of their income. Federal mortgage loan and guarantee programs provide direct benefits to builders and developers in the form of more liberal financing arrangements. These programs provide indirect benefits to low- and moderate-income individuals by expanding the supply of available rental housing.

The primary direct beneficiaries of rental housing tax expenditures are higher income real estate developers, syndicators, and investors. Less than 4 percent of all rental housing tax expenditure benefits accrued to persons with expanded gross income[2] below $15,000 in fiscal year 1977. For the most part, lower income persons benefit from rental housing tax expenditures only indirectly to the extent that low- and moderate-income housing supply is increased and tax savings are reflected in lower rents. The indirect effect of these tax expenditures on reducing rental payments for low- and moderate-income individuals is difficult to measure, although it is generally believed to be minimal. One 1972 study that attempted to measure the impact of accelerated depreciation on rent levels estimated that, in the long

[2] Expanded income is a broader income concept than adjusted gross income, the standard base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

run, a change from accelerated to straight-line depreciation would result in only a 1.5-percent average increase in rents.[3]

Because the major rental housing tax expenditures are tax deferrals, investments based upon these tax provisions become more attractive the higher an investor's marginal tax rate. Rental housing tax expenditures, the capital gains tax expenditure, and the leveraging of commercial credit made possible by limited partnership rules[4] are combined in rental housing "tax shelter" packages to produce significant after-tax savings for taxpayers in high-income brackets. Rental housing tax shelters are rarely, if ever, a profitable investment for taxpayers in marginal tax brackets below 50 percent.[5]

The Congressional Budget Office has estimated that approximately 40 to 60 percent of the tax expenditure benefits resulting from accelerated depreciation and the expensing of construction period interest and taxes go initially to the builder/developer, 5 to 20 percent to the syndicators, and 40 to 60 percent to the outside investors.[6] The tax expenditure benefits that go to outside investors in real estate developments are heavily concentrated among those with very high income, as shown in the table below. Syndicators and builder/developers generally have income somewhat lower than outside investors, but are still in the middle- and high-income classes.

Percentage Distribution of Tax Expenditures by Investor Income Class, Fiscal Year 1977

Expanded income class (thousands)	Accelerated depreciation	Construction period interest and taxes	5-year amortization	Tax-exempt housing bonds
0 to $10	2. 2	2. 0	0	0. 1
$10 to $20	3. 4	3. 3	0	2. 5
$20 to $50	18. 8	18. 7	20. 0	12. 1
$50 and over	75. 6	76. 0	80. 0	85. 3
Total	100. 0	100. 0	100. 0	100. 0

Source: Department of the Treasury.

Types of Housing Affected

Rental housing spending programs almost exclusively subsidize low- and moderate-income housing, while the bulk of the associated tax expenditures subsidize higher income housing. All HUD-administered programs, as well as the FmHA program in the Department of

[3] Paul Taubman and Robert Rasche, "Subsidies, Tax Law, and Real Estate Investment," in Joint Economic Committee, *The Economics of Federal Subsidy Programs*, Part 3—Tax Subsidies, July 15, 1972, p. 361. Some of the problems involved in trying to measure the impact of rental housing tax expenditures on rent levels are discussed in Congressional Budget Office, *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives*, May 1977, pp. 46–49.

[4] Limited partnership rules allow investors to finance a large percentage of real estate projects with borrowed funds and no personal liability in excess of their investment. At the same time, however, investors retain the tax expenditure benefits calculated on the total value of the project, so a taxpayer's depreciation and expensing deductions per dollar of actual personal investment are greatly increased. See *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives*, op. cit., pp. 15–22.

[5] *Real Estate Tax Shelter Subsidies and Direct Subsidy Alternatives*, op. cit., p. 6.

[6] *Ibid.*, pp. 10–12.

Agriculture, subsidize the construction or maintenance of low- and moderate-income housing through the use of mortgage loans and guarantees and long-term, guaranteed rental subsidies. FHA and GNMA credit programs stimulate, on the average, the construction of slightly higher-income rental facilities. The exemption of interest on State and local housing bond debt and the 5-year amortization for rehabilitation expenses primarily affect the supply of low- and moderate-income rental housing.

In sharp contrast, the two major rental housing tax expenditures primarily stimulate the construction of higher income housing. It is estimated that only 20 percent of all rental housing subsidized by accelerated depreciation and the expensing of construction period taxes and interest is low- or moderate-income housing.[7]

Overlap of Benefits

The construction of new housing for low- and moderate-income renters requires substantial Federal subsidies. Few tenants at these income levels can afford rent payments adequate to encourage builders to construct unsubsidized housing for this part of the housing market. No single Federal program provides a large enough subsidy to make up for this difference between new construction costs and the rents these tenants can afford to pay. As a consequence, a number of tax, direct grant, and loan subsidies must be combined in each project. Removal or reduction of any one of these subsidies will often mean that the project cannot be built.

This system of multiple subsidies reduces the size and visibility of each individual subsidy and makes budgetary coordination and control more difficult. It can also lead to additional administrative complexity for those involved in the construction of rental housing, since these multiple subsidies may require dealing with a number of different agencies, requiring additional paperwork, delays, and conflicting requirements.

Because of the complex interrelationships between tax and direct spending subsidies in the rental housing area, changes in one program will almost inevitably affect the others. A reduction in tax expenditure subsidies, for example, could make some planned section 8 projects economically infeasible. Thus, to maintain the same level of housing production under this program, increases in section 8 or some other subsidy program would be required.

Legislative Initiatives

The Carter Administration's urban policy initiatives, announced in March 1978, recommended an increase in budget authority for HUD's section 312 housing rehabilitation program. The Administration would increase funding to more than twice its present level, from $125 million to $275 million.

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[7] *Ibid.*, p. 38. These estimates are based on the tax law in effect on January 1, 1977. The provisions of the 1976 Tax Reform Act that phase down the tax expenditure allowing the expensing of construction period interest and taxes are expected to have a significant effect on the type of housing supported by real estate tax shelters over the next several years. Since the phase-down provision for low-income rental housing does not take effect until December 31, 1981, as compared to the provisions for middle and upper income housing, which are already being phased in, the percentage of rental housing tax expenditures that aid low-income housing units relative to middle and upper income units is expected to increase over the next several years.

In addition, the Administration's 1978 tax program requested several changes in existing tax law intended to curtail the widespread use of real estate tax shelters. The most important recommendation would significantly limit the use of accelerated depreciation for all but low-income rental housing.

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TRANSPORTATION

Tax Expenditures

The major transportation tax expenditure reduces the cost of automobile fuel for taxpayers who itemize their personal deductions by allowing them to deduct nonbusiness State and local gasoline taxes. This tax expenditure is expected to result in revenue losses of approximately $840 million in fiscal year 1979, compared to an estimated $7.2 billion in direct outlays for highway programs. A second transportation tax expenditure allows shipping companies to defer income tax payments on funds they set aside for construction or acquisition of new ships. This provision is expected to reduce tax revenues by $85 million in fiscal year 1979, versus expected outlays for maritime programs of $710 million.

Transportation tax expenditures are a small component of overall Federal transportation policy, accounting for only about 5 percent of total tax and direct spending in this area. Transportation tax expenditures are analyzed and described in greater detail on pages 99-104 in Part I of this compendium.

Spending Programs [1]

HIGHWAY PROGRAMS

Outlays for the major Federal highway programs are listed in the following table.

Estimated Outlays for Highway Programs

[In millions of dollars]

Program	Outlays		
	1978	1979	1980
Highway construction and maintenance	6, 400	6, 650	7, 014
Highway safety and other highway programs	538	557	599
Total	6, 938	7, 207	7, 613

[1] The Federal Government finances programs related to all major modes of transportation, including highways and automobile transportation, mass transit, and air, water, and railroad transportation. Only those spending programs associated with specific transportation tax expenditures will be discussed in this section. No tax expenditures are specifically targeted to air, railroad, or mass transportation. However, liberalized rules for claiming the investment tax credit do exist on a temporary basis for airlines and railroads. These liberalized rules will increase the revenue losses resulting from this tax expenditure by approximately $100 million in fiscal year 1979.

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Highway Construction and Maintenance

The Federal Government maintains a large commitment to the construction of major highway systems, with highway program outlays accounting for approximately 41 percent of total Federal direct spending for transportation in fiscal year 1979. The largest single highway program was established under the Federal-Aid Highway Act of 1956. This program provides matching grants to States on a 90-percent Federal, 10-percent State cost-sharing basis for the construction of interstate highways and on a 70-percent, 30-percent basis for other highway construction. Funding under this program has also been available in recent years for major highway maintenance projects.

In the Federal-Aid Highway Act, the Congress adopted the principle that the bulk of the country's highway construction effort was to pay for itself through "user" taxes expressly earmarked for a Federal highway trust fund. The highway trust fund currently supports over 90 percent of all highway construction programs and is financed by highway excise (user) taxes, including those on fuels, new trucks, buses, trailers, truck parts, tire rubber, lubricating oils, and by annual taxes on trucks exceeding a gross weight of 26,000 pounds.

Highway Safety and Other Highway Programs

Other Federal highway programs include the beautification, recreation, off-systems, and access road construction projects of the Federal Highway Administration, the highway safety research and development projects of the Federal Highway Administration, and the traffic and highway safety programs of the National Highway Traffic Safety Administration.

MARITIME PROGRAMS

U.S. ocean shipping and shipbuilding industries receive extensive Federal direct spending assistance. The largest Federal outlays for the maritime industry are for operating and construction differential subsidy programs. Established by the Merchant Marine Act of 1936, these subsidy programs are administered by the Maritime Administration in the U.S. Department of Commerce. The Federal Government also provides funds for other maritime-related programs, including research and development, the U.S. Merchant Marine Academy, and health, education, and financial programs related to the industry. Outlays for the major maritime programs are listed in the following table.

Estimated Outlays for Maritime Programs

[In millions of dollars]

Program	Outlays		
	1978	1979	1980
Operating differential subsidies	352	387	394
Construction differential subsidies	213	182	159
Other	128	141	151
Total	693	710	704

Operating Differential Subsidies

Maritime operating subsidies, which account for the largest single source of maritime outlays, are provided to selected U.S. steamship lines and bulk operators in service in U.S. foreign commerce. Recipients are required to use U.S.-built and U.S.-registered vessels, manned exclusively by U.S. citizens. Subsidies awarded shipping operators are calculated by the Maritime Administration to offset the difference in operating costs between American operators and their foreign competitors.

U.S. shipboard labor costs are the primary factor contributing to higher U.S. operating costs relative to foreign operators. Operating subsidies, on the average, pay for more than 70 percent of the labor costs aboard subsidized U.S. vessels, and approximately 85 percent of all operating subsidies cover these labor cost differentials.

Most maritime operating subsidies are paid to the 11 subsidized U.S. shipping companies that provide service on all but a few of the important U.S. foreign commerce trade routes. At one time, subsidies were paid for the operation of passenger vessels as well as cargo vessels, but in 1978 the last U.S. passenger service ended. A modest fraction of all operating subsidies have recently been paid to the operators of dry bulk carriers and tankers under provisions of the Merchant Marine Act of 1970.

Construction Differential Subsidies

The second major maritime spending program provides construction differential subsidies to U.S. shipbuilders. These subsidies are intended to reduce the costs of American ship construction to the estimated cost of building the same vessel in a foreign shipyard. Construction subsidies require that the buyer of the ship be a U.S. citizen and that the ship be added to the U.S.-flag fleet for use in U.S. foreign commerce.

More than 160 orders for new, subsidized American ships were filled between 1957 and 1970 at a subsidy cost of $1.6 billion. In addition, a major new shipbuilding program went into effect after the passage of the Merchant Marine Act of 1970 primarily to add dry bulk vessels and tankers to the U.S. fleet. Seventy-one vessels had been contracted for under this program by December 1977.

Other Maritime Programs

U.S. maritime industries also benefit from several smaller Federal spending programs. The Maritime Administration conducts research and development programs to develop methods, equipment, and systems intended to bolster the economic competitiveness of the maritime industry. The Government also operates the U.S. Merchant Marine Academy at Kings Point, N.Y., for the purpose of training officers for the U.S. shipping fleet and helps support six similar State maritime academies. Construction loans and mortgages on U.S.-flag vessels built in the United States may be guaranteed against default under a special program administered by the Maritime Administration. The Maritime Administration also offers U.S. shipowners insurance against war loss or damage when commercial in-

surance is not available. In addition, the U.S. Public Health Service operates hospitals and clinics that provide health care services to certain qualifying groups of beneficiaries, the largest of which is American seamen.

Relationships Between the Tax Expenditures and Spending Programs

Types of Transportation Subsidized

Tax expenditures provide specialized benefits only for water and automobile transportation. Direct spending for transportation is much wider in scope, providing benefits for nearly all major modes of transportation. Air, railroad, and mass transportation systems, which receive no specific tax expenditure subsidies, account for approximately 46 percent of anticipated fiscal year 1979 outlays for transportation.

Although only two tax expenditures provide specific transportation subsidies, all private transportation companies with tax liability receive Federal aid from the several general investment tax expenditures. In particular, the railroad and airline industries, with very large capital investment requirements, receive substantial tax expenditure benefits from accelerated depreciation tax provisions and the temporarily more liberal investment tax credit rules in effect for these industries through 1983.

Mass transit systems, in addition, are subsidized by the exclusion from taxable income of interest on State and local debt. Tax-exempt transportation bonds provide State and local governments with an important source of revenue for their portions of major mass transportation construction costs.[2]

HIGHWAY PROGRAMS

Distribution of Benefits

Highway construction spending programs benefit both business and nonbusiness drivers. The deduction for nonbusiness State and local gasoline taxes, however, benefits only nonbusiness drivers who itemize their personal expenses. This tax expenditure benefits primarily individuals in the middle- and upper-income groups. Recent increases in the standard deduction have further concentrated its benefits among taxpayers with income over $20,000; taxpayers with expanded gross income [3] exceeding $20,000 received 65 percent of the benefits from this tax expenditure in fiscal year 1977. Over three-fourths of the total tax expenditure benefits went to individuals with expanded gross income between $15,000 and $50,000.

To the extent that funds supporting highway construction spending programs equal highway user tax revenues, these spending programs do not provide "subsidies" in the same sense as, for example, funds provided the shipping industry from general revenues under the

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[2] The exclusion of interest on State and local debt is discussed in detail on pp. 347-358, the section on general purpose fiscal assistance tax expenditures and related spending programs.

[3] Expanded income is a broader income concept than adjusted gross income, the standard base used to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

construction differential program. The benefits to drivers of direct highway spending programs (measured in this fashion) generally are about equal to user taxes, since the Federal portion of highway construction outlays is, for the most part, fully funded by user taxes without requiring additional general revenues. Therefore, there is no subsidy to all drivers as a group.

However, the distribution of user taxes among different types of drivers does not generally correspond to the benefits each group receives from the direct spending program; some drivers receive net subsidies, while other groups pay more in user taxes than they receive in highway benefits.

Highway construction costs were allocated to different types of users in several studies by the Federal Highway Administration in order to estimate the distribution of highway benefits relative to user taxes among drivers.[4] Higher costs were assigned to heavy vehicles, since they require wider lanes and stronger lane construction than do light vehicles. Under these assumptions, automobile owners and heavy truck operators were found to pay less than their share of user taxes in relation to benefits received. Operators of light trucks, on the other hand, were found to overpay. Although the average per car underpayment is, according to these studies, quite small, the subsidy provided all automobiles as a group is substantial and may average more than $100 million annually.

Overlap of Benefits

Automobile owners who itemize their personal expenses on their tax returns and who are in a relatively high marginal tax bracket receive measurable overlapping benefits from both tax and direct Federal transportation subsidies. For example, a commuter in the 50-percent marginal tax bracket who itemizes personal deductions typically receives a gasoline price reduction of approximately 6 percent, as well as the subsidy, discussed above, that is provided by the direct spending highway programs.[5]

Automobile traffic in the aggregate receives substantial overlapping benefits. The estimate of highway spending program subsidies cited in the studies by the Federal Highway Administration, together with tax expenditure data, suggest a total Federal subsidy for private automobile traffic in fiscal year 1979 of nearly $1 billion.

MARITIME PROGRAMS

Distribution of Benefits

The tax expenditure associated with the maritime industry takes the form of a tax deferral. Shipowners are permitted to deposit assets and earnings in special "capital construction" funds earmarked for new vessel construction. All deposits of earnings are deductible from gross income, and no tax is collected on the earnings of assets already

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[4] Federal Highway Administration, *Allocation of Highway Cost Responsibility and Tax Payments: 1969*, May 1970; Federal Highway Administration, *Federal Highway Cost Allocation: An Examination of Current Trends*, December 1975.

[5] Gasoline price reduction estimate assumes a gasoline price of 65 cents per gallon, including an 8-cent-per-gallon State tax.

in the funds. In principle, these foregone taxes will eventually be collected through reduction in the depreciation base of vessels built with these funds. Thus, the benefit takes the form of an interest-free loan rather than tax exemption. However, deferrals often can be extended for so long as to make them practically equivalent to tax exemption.

Tax expenditure benefits produced by the deferral of tax on capital construction funds depend on the taxpayer's marginal income tax rate. Since most U.S. shipowners are corporations, their income is generally taxed at the same marginal rate of 48 percent, and they receive the same benefit per dollar of deposit. However, since not all are equally profitable, opportunities for claiming the tax benefits differ. Companies suffering losses and new firms without tax liability cannot directly benefit from this tax expenditure program. Such firms that wish to build vessels are unable to take advantage of this tax expenditure unless they "share" the associated expenditures with other parties, such as financial institutions, that have income to shelter. By contrast, direct Federal operating and construction subsidies are given to firms whether they are profitable or not; the size of the direct subsidies is unrelated to the firm's marginal tax bracket or profit level.

Administration

Direct maritime spending programs involve more detailed and costly administration than associated tax expenditure programs. Shipowners and shipbuilders must submit applications to the Maritime Administration in order to receive operating or construction subsidies. Applications are then considered in relation to the available funds. In practice, however, funds for these programs have been readily available, although operating subsidy contracts have generally been signed with established operators, not with new entrants to the business.

Shipping companies must submit their activities to a certain degree of Government supervision in return for accepting operating subsidies, although these regulations have not in the past significantly affected their operations. The Maritime Administration, for example, may examine and audit company financial records. Operating subsidy recipients are also prohibited from owning, chartering, or operating foreign-flag vessels, or from operating vessels in the domestic trades.

Fewer requirements are imposed on the recipients of construction subsidies than on the recipients of operating subsidies. Construction subsidies have been more readily available to newcomers to the shipping business than operating subsidies. However, even in the case of construction subsidies, general application requirements place certain costs and constraints on companies that receive this type of Federal aid.

By contrast, the rules defining eligibility to participate in the capital construction tax expenditure program are less restrictive. Permission must be obtained from the Maritime Administration to establish a capital construction fund, but the Administration has less discretionary authority to withhold permission than it has to withhold construction and operating subsidies. Furthermore, there are no budgetary constraints on the size of the tax expenditure program similar to those that exist with the two maritime subsidy programs.

The size of the program depends instead on the amount of deposits made by private owners in capital construction funds.

Efficiency

The tax benefits resulting from the deferral of certain maritime construction funds do not accrue solely to shipowners or shipbuilders. Tax shelter arrangements are available that allow the tax savings of deferral to be shared with third parties, such as financial institutions, that wish to shelter a part of their profit from tax. This sharing of tax benefits is less efficient than the direct spending alternatives to the extent that it dilutes the incentive effects of the tax subsidy program. A spending program that provided a construction subsidy equal to the total tax expenditure revenue loss directly to the intended beneficiary would have a greater incentive effect per dollar of Federal outlay than the current tax subsidy for maritime construction.

On the other hand, tax shelter arrangements make it possible for members of the maritime industry who might otherwise be unable to receive the tax expenditures—because they have no profits on which to pay tax—to do so by selling their eligibility to others. In this regard, the selling of tax benefits probably increases the overall incentive effect of this tax subsidy program relative to other tax expenditure programs whose benefits are not or cannot be sold in this fashion.

No studies have been conducted to determine the extent to which the shipping tax expenditure has increased the number of ships built above the level that would exist in the program's absence. To the extent that shipbuilders receive tax benefits for construction that would have taken place in the program's absence, this tax expenditure is inefficient.

Critics of direct spending maritime programs claim that since operating subsidies are computed as the difference between U.S. and foreign costs, operators have little incentive to economize on resources. The Government claims any cost savings as a reduction in subsidy; alternatively, the Government pays the bill for inefficient production in the form of increased subsidies. Some critics have alleged that this feature of the operating subsidy program has in the past resulted in the overmanning of U.S. vessels and the inefficient use of shipboard labor. Moreover, they argue that this method of calculating subsidies allowed maritime labor unions to obtain larger wage increases than they could have achieved if their wage claims had to be paid in full by the shipowners themselves.

Although in principle the Government's interests were protected by statutory language limiting Federal subsidies to "fair and reasonable" costs, it proved impossible in practice to enforce this standard. As a result, legislation in 1970 tied "subsidizable wage costs" to an index of wage rates for workers in other industries in order to limit increases in the amount of subsidy that the Government would pay.

Construction differential subsidies are also computed as the difference between U.S. and foreign costs. In this case, however, competition between U.S. shipbuilders for new vessel orders can be expected to work against any inefficiency that might be created by this method of calculation. Nevertheless, the relatively low efficiency of the U.S. shipbuilding industry is probably not unrelated to the fact that it enjoys a protected market in which the demand for its products is largely sustained by Federal subsidies.

Legislative Initiatives

The House of Representatives voted to eliminate the deduction for nonbusiness State gasoline taxes in August 1978. The Ways and Means Committee, whose recommendation the House approved in voting to terminate the deduction, had adopted the view that State gasoline taxes, like those on the Federal level, are user charges for road construction and maintenance services and, therefore, should not be deductible any more than the cost of gasoline itself. Some critics of the gasoline deduction believe that the deduction simply acts as a Federal tax rate reduction for those who have large driving costs and itemize personal expenses.

The House also voted to eliminate the gasoline deduction in 1977 during consideration of the National Energy Act. The House considered the subsidy for gasoline consumption provided by the deduction to be in conflict with energy conservation efforts. However, the Ways and Means Committee noted in its report on the tax components of the energy legislation that the amounts deducted for gasoline taxes on a per capita basis are generally so small that many consumers may not perceive that repeal of the deduction would increase the cost of gasoline. Thus, the committee did not predict that repeal would produce major energy savings. Nevertheless, it found no justification for the present tax expenditure and stated that repeal would signal a serious Federal energy conservation effort.[6]

The 1977 House provision repealing the deduction was tentatively dropped in conference. Members believed that the issue of gasoline tax deductions should be addressed in the context of tax reform rather than energy legislation.

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[6] House Ad Hoc Committee on Energy, *National Energy Act*, H. Rept. No. 95-543, 95th Cong., 1st sess., 1977, pp. 57–59.

HIGHER EDUCATION

Tax Expenditures

Tax expenditures account for a large portion of total Federal assistance for higher education. The major tax expenditures providing benefits directly to students and their families are the exemption for student dependents, the deduction for interest paid on student loans, and the exclusion from taxable income of scholarships, grants, fellowships, GI bill education benefits, and social security student benefits.

The major tax expenditures that aid educational institutions are the tax deduction for charitable contributions, the exclusion from taxable income of unrealized capital gains on gifts and bequests to higher education institutions, the deduction of State and local taxes used to support higher education, and the exclusion from taxable income of interest on State and local borrowing for higher education purposes.[1]

Higher education tax expenditures will result in revenue losses of approximately $4.8 billion in fiscal year 1979, compared to outlays for higher education spending programs of approximately $8.7 billion.[2] Tax expenditures related to higher education are discussed in greater detail on pages 107–110 and 117–119 in Part I of this compendium.

Spending Programs

Federal higher education policy has three primary objectives: providing equal access to higher education regardless of family background; maintaining the financial stability of colleges and universities; and relieving the financial burden on families caused by education costs. Outlays for the major Federal spending programs for higher education are listed in the following table.

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[1] The deduction for interest paid on student loans is a component of the broader tax expenditure allowing the deduction of interest in consumer credit. The deduction for State and local taxes used to support higher education is a part of the broader tax expenditure allowing deductions for nonbusiness State and local general revenue taxes, including real and personal property taxes, sales taxes, and income taxes. The exclusion of interest on State and local borrowing for educational purposes is a portion of the broader tax expenditure which excludes interest on State and local debt from taxable income. The exclusion of unrealized capital gains on gifts and bequests to higher education is a part of the broader tax expenditure excluding from taxable income unrealized capital gains transferred at death or by gift.

[2] The higher education tax expenditure estimate assumes that 9.5 percent of all State and local general expenditures and debts are for higher education and, therefore, that 9.5 percent of the revenue losses from the deductions for nonbusiness State and local general revenue taxes and the exclusion for interest on State and local debt support higher education. However, this estimate does not include that portion of the exclusion of interest on consumer credit that can be attributed to interest on student loans.

Estimated Outlays for Higher Education

[In millions of dollars]

Program	1978	1979	1980
Federal grants to students:			
Basic education opportunity grants	1, 592	1, 837	1, 982
Supplemental education opportunity grants	231	301	325
Work study program	411	482	520
State student incentive grants	51	60	65
GI bill education benefits	3, 384	3, 094	2, 801
Social security student benefits	1, 800	2, 000	2, 200
Student loan programs:			
National direct student loans [1]	282	311	357
Guaranteed student loans [1]	619	534	760
Aid to institutions: [2]			
Strengthening developing institutions	107	120	148
Total	8, 477	8, 739	9, 158

[1] Annual loan volume is in many ways a better measure than outlays of program activity in any given year for higher education direct and guaranteed student loan programs. Annual loan volume reflects the sum of all loans obligated during a fiscal year under direct loan programs and the value of all commercial loans insured under loan guarantee programs. Outlays, on the other hand, reflect only administrative costs and net lending activity—interest subsidies, loan defaults, new loans, and repayments on prior-year loans. As such, outlay figures tend to underestimate the full effect of these programs. The total amount of loan funds available under the national direct student loan program, according to the HEW Office of Education, will be approximately $605,000,000 annually in fiscal years 1978–80. The amount of loans guaranteed under the guaranteed student loan program is expected to be $1,648,000,000 in fiscal year 1978, $2,673,000,000 in fiscal year 1979, and $2,949,000,000 in fiscal year 1980.

[2] There are a number of minor programs that provide aid to institutions that render certain student services. Also, a substantial amount of Federal funds go to institutions for research purposes. These latter programs have not been included in this table since they primarily involve the purchase of services by the Federal Government, and do not have as their major purpose the dispersing of aid to institutions. To some extent, however, these research grants help defray institutional costs of instruction.

BASIC EDUCATION OPPORTUNITY GRANTS

Basic education opportunity grants, established in 1972, provide financial assistance to students carrying at least half the normal full-time course load at colleges, post-secondary vocational schools, and technical-trade institutions. Eligibility is based on need, determined by an annually revised formula that takes into account family income, assets, taxes, the number of family wage earners, and family size. Grants are generally restricted to students with family income below $20,000, with approximately 95 percent of the funds going to those with family income below $15,000. The amount of each qualified student's grant is the lesser of (1) $1,800 minus the family's expected contribution,[3] or (2) one-half the cost of attendance.

SUPPLEMENTAL EDUCATION OPPORTUNITY GRANTS

Supplemental education opportunity grants (formerly called educational opportunity grants) were established in 1965. Under national criteria, those Federal funds are awarded by institutions to students with exceptional financial need as determined by the institutions. The size of the grant is based on the student's financial resources, and ranges from $200 to the lesser of (1) $1,500 per academic year, or (2)

[3] Appropriations for fiscal year 1978 effectively reduce the maximum award from $1,800 to $1,600. A family is expected to contribute 20 percent of its first $5,000 of discretionary income, and 30 percent of discretionary income above $5,000.

one-half the total financial aid provided to the student by the institution.

WORK STUDY PROGRAM

The college work study program, started in 1965, provides financially needy students with part-time, subsidized employment to help defray the costs of higher education. Together with supplemental education opportunity grants and national direct student loans (discussed below), they form "packages" of Federal aid by which institutions assist students. Work study grants to institutions are authorized for partial reimbursement of wages paid to students participating in a work study program in a public or private nonprofit organization. Currently, Federal funds pay 80 percent of the student's wages, with the remainder paid by the institution, the employer, or some other donor.

STATE STUDENT INCENTIVE GRANTS

State student incentive grants were established in 1972 and provide State assistance to full-time undergraduate students. Eligibility is based on financial need as determined by the States. As authorized, the grants provide up to $1,500 per academic year. The Federal Government reimburses the States for 50 percent of the amount of these grants.

GI BILL EDUCATION BENEFITS

The GI bill was enacted in 1966 and currently provides virtually all veterans education benefits for those who served during the period from February 1956 through December 1976. This program grants up to 45 months of benefits for veterans enrolled in approved courses of instruction. Veterans receive a monthly education assistance allowance that partially subsidizes both living expenses and education costs. The size of a veteran's allowance depends upon the number of his dependents and whether school attendance is full- or part-time. Currently, those with no dependents who attend school full-time receive $310 per month. Eligibility for these benefits extends for a period of 10 years after separation from service.

The most recent veterans education program assisting military personnel was enacted in October 1976 and covers those who enter the service after December 1976. The new program differs from the previous ones in that those wishing to participate must make contributions while they are in the service. The Federal Government matches each dollar of a participant's contribution with $2 of Government funds.

SOCIAL SECURITY STUDENT BENEFITS

Unmarried, 18- to 21-year-old, full-time student dependents of dead, disabled, or retired workers covered by social security have received social security benefits since 1965. Currently, about one-eighth of all full-time students between 18 and 21 years old draw such benefits, averaging over $1,900 a year. Maximum social security student benefits are half those paid to the retired or disabled worker

or three-fourths of the amount the deceased worker would have received in retirement benefits. However, 43 percent of the student beneficiaries receive less than the formula amount because of the family maximum rule which generally restricts total family payments to no more than 175 percent of the ex-worker's benefit.

NATIONAL DIRECT STUDENT LOANS

The national direct student loan program, established in 1958, offers long-term, low-interest funds to financially needy students at eligible post-secondary institutions. A revolving loan fund is created at each institution for this purpose, with 90 percent of the capital provided by the Federal Government and 10 percent by the institution. These loans bear a 3-percent interest charge, generally beginning 9 months after the student ceases at least part-time attendance. The size of loans provided under this program depends upon the student's financial need as determined by the institution under the same national criteria used by the supplemental education opportunity grant and work study programs. The portion of total financial need covered by each of these three programs is determined by the institution after accounting for aid provided by basic education opportunity grants.

GUARANTEED STUDENT LOANS

The guaranteed student loan program, created in 1965, helps students borrow from private lenders to pay for training at colleges, universities, and vocational schools. Loans carry a 7-percent interest charge and are either guaranteed by a State or private nonprofit agency or insured by the Federal Government. A maximum of $2,500 per academic year ($5,000 for graduate study) may be borrowed in most States if need is justified by education costs. Total loans outstanding may not exceed $7,500 for undergraduates and vocational students or $15,000 for graduate students. Loan interest is paid by the Federal Government while students are in school and during a 12-month grace period following completion or withdrawal from school, provided adjusted family income is less than $25,000 per year.[4] Over 95 percent of all GSL borrowers receive this "in-school" subsidy.

STRENGTHENING DEVELOPING INSTITUTIONS

The strengthening developing instutitions program began in 1965 and provides financial assistance to institutions characterized by high percentages of low-income and/or minority students, limited program offerings, and limited financial means which hamper the ability of the institutions to compete with relatively financially secure public and private institutions. Eligibility requires that institutions must: (1) be public or non-profit; (2) have been in existence, with some exceptions, for at least 5 years; (3) be accredited or making reasonable progress toward accreditation; and (4) provide evidence of their ability to use program funds effectively. Grants are awarded competitively on the basis of realistic, long-range plans for development.

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[4] An adjusted family income of $25,000 corresponds to an adjusted gross income of about $31,000.

Relationships Between the Tax Expenditures and Spending Programs

Distribution of Benefits

INDIVIDUAL BENEFICIARIES

Except for guaranteed student loans and GI bill education benefits, over two-thirds of all student aid spending program benefits are concentrated among students with family income below $10,000. This distribution results primarily because all of these programs, except for social security student benefits, make financial need a major consideration in distributing benefits. Guaranteed student loans are not needs-tested, but loan recipients qualify for the in-school subsidy only if their family's income is less than $31,000. GI education benefits and social security student benefits are provided to persons in all income classes without regard to need. However, social security benefits are distributed progressively across income classes since recipients come from families whose incomes are generally low because the primary worker is dead, disabled, or retired. The table on page 278 indicates the distribution of spending program outlays for higher education by income class.

In contrast to the spending programs, higher education tax expenditures provide benefits regardless of family need, but provide no educational support to those low-income families without tax liability. Moreover, since the size of tax expenditure benefits depends upon the recipient's marginal tax bracket, taxpayers in relatively higher brackets receive proportionally greater benefits than those in lower brackets.

Higher education tax expenditures, in the aggregate, are more concentrated among middle and upper income taxpayers than spending program benefits. For example, while 27 percent of the benefits of the parental exemption for students—the largest tax expenditure aiding individuals—accrued to families with expanded gross income [5] over $20,000 in fiscal year 1977, the table on page 278 indicates that, in the same year, only 1 percent of all basic and supplemental education opportunity grants and work study benefits went to those with family adjusted gross income above $20,000.

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[5] Expanded income is a broader income concept than adjusted gross income, the standard base used to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

Distribution of Higher Education Outlays to Individuals by Income Class, Fiscal Year 1977 [1]

[In millions of dollars]

Program	Adjusted gross parental income for dependent students		
	$0 to $10,000	$10,000 to $20,000	$10,000 and over
Federal grants to students:			
Basic education opportunity grants	1,166	273	(3)
Supplemental education opportunity grants	189	57	2
Work study program	233	104	21
GI bill education benefits	1,304	1,463	413
Student social security benefits	694	398	193
Student loan programs:			
National direct student loans [4]	151	114	30
Guaranteed student loans [4]	188	238	22
Total	3,925	2,647	681

[1] Distribution of State student incentive grants unavailable.
[2] Most self-supporting students have incomes below $10,000. The benefits received by self-supported students are reflected in the amounts shown for dependent students, with 90 percent going to the $10,000 and less income class and the remainder to the $10,000 to $20,000 income group.
[3] Amount insignificant.
[4] Numbers reflect only the value of interest subsidies associated with these programs, and not the total value of loans made under these programs in fiscal year 1977.

Source: Congressional Budget Office, *Federal Aid to Postsecondary Students: Tax Allowances and Alternative Subsidies*, February 1978.

INSTITUTIONAL BENEFICIARIES

Tax expenditures and spending programs directly assisting colleges and universities benefit very different types of institutions. The strengthening developing institutions program primarily assists colleges and vocational schools that need funds to compete with other public and private schools that are relatively secure financially. In contrast, the deduction for charitable contributions and the exclusion of unrealized capital gains on gifts and bequests to educational institutions benefit mainly those institutions that most effectively attract these forms of charitable giving. These latter institutions are very often long established and relatively secure financially; few would qualify as developing institutions.

The exemption of interest income from State and local bonds makes it easier for State and local governments to raise funds to support higher education. The benefits of this tax expenditure go to public rather than private institutions.

Empirical studies have not yet reached a consensus as to the effectiveness of the charitable contribution deduction in encouraging giving. Some studies conclude that the deduction increases charitable giving by more than the foregone Treasury revenue and that educational institutions gain more from the deduction than they would from a tax credit or matching grant program. The deduction for

charitable contributions is, however, not likely to provide much assistance to developing institutions. Thus, direct Federal spending to strengthen developing institutions complements tax expenditures in this area.

Expanding Access to Higher Education

Education benefits distributed according to need expand access to higher education more efficiently than benefits distributed across all income classes. Programs distributing benefits on a needs basis provide aid to families with only marginal resources who otherwise might not be able to finance the costs of higher education. In contrast, tax expenditures and outlays distributed without regard to need often provide benefits to students from middle and upper income families who are more likely to have the resources to finance higher education without additional Government aid. For many of these students, the provision of aid has little or no effect on their ability to attend an institution of higher education.

The relative size of Federal educational benefit payments also has an important effect on expanding student access to higher education. Educational aid "packages," made up of varying amounts of direct grants, student loans, and work study wages, often finance a substantial percentage of total educational expenses, significantly affecting a student's ability to attend an educational institution.

Tax expenditures, on the other hand, provide low levels of financial aid relative to total college costs. The parental exemption for dependent students is worth only $150 per student for families taxed at the median marginal rate of 20 percent. The tax expenditures that arise from the exclusion of scholarship, fellowship, GI bill, and student social security benefits are only a small percentage of the value of these direct payments for most recipients. Moreover, since tax expenditure benefits are increased in value for recipients in higher marginal tax brackets, low-income persons with the least ability to afford a college education receive the smallest tax expenditure benefits. Present tax expenditure provisions provide, at most, only marginal assistance in financing the costs of higher education.

Effect on Tuition Costs

Both tax and direct spending programs that provide student aid may allow institutions to raise tuitions, capturing some or all of the benefits meant for students. It is difficult to determine the extent to which institutions engage in this practice. Several theories have been offered, but none has been empirically tested. In general, institutions experience conflicting pressures to remain both financially viable and price competitive.

Spending and tax programs that distribute benefits to a narrowly defined group of students may be less likely to result in tuition increases compared to more widely available tax or spending programs. Subsidy-induced tuition increases may drive away a significant number of unaided students as well as the students whose education assistance benefits are captured by the institution. Schools that raise tuitions may also find themselves in a weaker competitive position if other institutions do not adopt similar pricing policies.

Administration

Compared to the current tax expenditures for higher education, which distribute funds with few eligibility restrictions, the higher education spending programs target benefits to those with financial need and, therefore, involve more administrative costs and require more effort on the part of applicants to obtain funds. Under the grant and loan programs, student applicants must document need by submitting personal financial statements which require screening and evaluation by the administering agency or institution. Also, administrative judgments are often necessary regarding the distribution of limited appropriations among qualified applicants. The inevitable existence of fraud and abuse increases the administrative burdens in these programs. In the loan programs, high default rates are a problem because student loan recipients are often difficult to find for billing purposes after their graduation.

In contrast, the distribution of higher education assistance through current tax expenditures involves relatively little paperwork for taxpayers or the Internal Revenue Service. Since recipients are not required to document financial need, benefits can be obtained by merely claiming the relevant deductions, exclusions, or exemptions on annual tax forms. The validity of these claims is checked by the Internal Revenue Service through the auditing of tax returns. This procedure is less burdensome and costly than the screening of grant and loan applications because audits are limited to a small fraction of tax returns each year. However, the amount of revenue lost each year as a result of incorrect or fraudulent higher education tax expenditure claims that go unaudited is not known and could be substantial.

The administration of existing tax expenditures is also simpler than that of the spending programs because there are no statutory limits on the amount of aid that can be distributed among beneficiaries, and default problems do not arise because the tax expenditures need not be repaid.

Overlap of Benefits

All Federal spending programs for higher education, except for the work study and strengthening developing institutions programs, give rise to tax expenditures for recipients with tax liability, producing an overlap between tax and spending program assistance for such recipients. In the case of grant programs, tax expenditures result from the exclusion of grant benefits from taxable income. In the case of loan programs, tax expenditures arise from the deductibility of nonbusiness and noninvestment related interest payments. Because these education spending programs are largely needs tested, their benefits are concentrated among families in the lower tax brackets. Consequently, the tax expenditures associated with these direct spending programs are smaller, on average, than they would be if direct spending benefits were distributed without regard to need to those in higher marginal tax brackets.

Legislative Initiatives

Both the Senate and the House of Representatives recently have passed college tuition tax credits as a form of higher education financial aid for middle-income families not usually eligible for direct Federal assistance. These bills would allow full-time undergraduate and post-secondary vocational students or their parents a credit against tax liability of either 25 or 50 percent of eligible education expenses. The annual credit would be limited to no more than $250 or $500 per taxpayer. The House and Senate provisions would be phased in either over 2- or 3-year periods and would result in annual revenue losses when fully effective of $1.1 billion under the House bill and $2.8 billion under the Senate version.

Tuition tax credits would provide education assistance without regard to need, resulting in benefits to taxpayers at all income levels. Unlike existing education tax expenditures, which are in the form of exclusions, exemptions, and deductions, the magnitude of a tuition tax credit would not depend on a taxpayer's marginal tax bracket. Since neither the House nor Senate credit is refundable, however, tuition assistance would not be provided to low-income persons without tax liability.

Moreover, benefits to low- and middle-income students from a tax credit would be limited if the credit were reduced or eliminated for students receiving direct Federal student grants or other tax-exempt educational assistance. Only low- and middle-income students currently receive such assistance. The bills approved by each House include rules that would reduce or eliminate tuition tax credits for students who receive such direct assistance.

The distribution of benefits of a tuition tax credit with an offset provision would be concentrated among taxpayers with family income between $15,000 and $40,000. Although a larger percentage of benefits under this type of provision would accrue to low-income persons than under existing tax expenditure provisions, benefits for low-income persons would be reduced significantly by the offset requirement.

As an alternative to the tuition tax credit, the Carter Administration proposed a sizeable expansion of the present direct loan, work study, and grant programs, with particular emphasis on expanding the basic education opportunity grant program, in order to funnel aid to middle-income families that presently receive few benefits or are ineligible for program support. This proposal would aid middle-income families in financing higher education costs without necessarily funding those in higher income brackets. It would also provide larger grants to fewer students than the tuition tax credit proposals. The Carter proposal, however, would involve somewhat higher administrative costs.

The Senate has passed and the House is considering modified versions of the Carter proposal as additions rather than as alternatives to tuition tax credit legislation.

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CHILD CARE SERVICES

Tax Expenditures

Taxpayers are allowed an annual tax credit of up to $800 for expenses incurred for child care services.[1] This tax expenditure is expected to produce a revenue loss of $575 million in fiscal year 1979, about one-quarter of total Federal support for child care. The tax expenditure for child care services is discussed in greater detail on pages 123–124 in Part I of this compendium.

Spending Programs

The Federal Government currently supports child care with a variety of spending programs. About 2.6 million children were served by Federal programs costing approximately $1.7 billion in fiscal year 1977. The outlays for the major child care programs are listed in the following table.

Estimated Outlays for Child Care

[In millions of dollars]

Program	1978	1979	1980
Social service grants (Social Security Act, title XX)	800	800	800
Head Start	558	632	698
Child care food service program	125	149	178
AFDC work expense allowance (SSA, title IV–A)	193	195	205
Total	1,676	1,776	1,881

SOCIAL SERVICE GRANTS (SOCIAL SECURITY ACT, TITLE XX)

The largest single Federal spending program supporting child care services is title XX of the Social Security Act. Title XX authorizes up to $2.5 billion annually in matching grants to States for the support of social services for low-income families, including child care programs. Moreover, a 1976 amendment to title XX (Public Law 94–401) authorized an additional $200 million in unmatched funds expressly for child care services in fiscal years 1977–78. This

[1] Expenses incurred for the care of an incapacitated dependent or spouse are also eligible under this tax expenditure.

authorization is likely to be extended for fiscal year 1979.[2] The Department of Health, Education, and Welfare estimates that about $800 million, or almost one-third of the $2.5 billion in title XX outlays, was used for child care services in fiscal year 1977.

Families receiving child care services under title XX must meet certain State eligibility requirements subject to Federal guidelines. Federal law requires that a recipient's family income be no greater than 115 percent of the State's median income adjusted for family size. In addition, States are required to charge service fees to families with income exceeding 80 percent of the median State income adjusted for family size. Although they are free to charge service fees to families with incomes below 80 percent of the State median, most States provide services to these families either without charge or at a nominal cost. Federal regulations also require that 50 percent of all title XX funds be targeted to persons receiving or eligible for the aid to families with dependent children program, medicaid, or supplemental security income benefits.

HEAD START

Head Start is a comprehensive preschool program providing free medical, educational, and social services to children. Ninety percent of the enrollment places are reserved for children from low-income families. The public and nonprofit private agencies that administer the program are required to provide 20 percent of their costs from non-Federal sources; the annual Head Start appropriation provides the remaining 80 percent. HEW estimates that the Head Start program served approximately 359,000 children in fiscal year 1977 with an appropriation of $475 million.

CHILD CARE FOOD SERVICE PROGRAM

The child care food service program provides child care institutions with funds and donated food commodities to help defray the cost of serving meals. Any licensed public or private nonprofit child care institution is eligible to receive this subsidy. The amount of the subsidy varies with the types of meals served and the family income of the children. In fiscal year 1977, approximately 580,000 children benefitted from this program at a cost of $120 million.

AFDC WORK EXPENSE ALLOWANCE (SSA TITLE IV-A)

The aid to families with dependent children (AFDC) program is another source of Federal support for child care. In determining eligibility for AFDC benefits, applicants may deduct from earned income child care and other expenses necessary to find employment. Because AFDC benefit levels are inversely related to the recipient's income, those who claim a deduction for child care expenses receive more cash benefits than they would if the deduction were not allowed.

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[2] The Congress intended that the $200 million in additional, unmatched title XX funds provide States with the financial resources necessary to make their child care services meet Federal staffing requirements. The extent to which these funds have increased the overall level of child care is, however, unclear. Because these funds are not matched by the States, and since regular title XX funds may be diverted to social services other than child care, many States may have simply used their portions of the additional $200 million to support child care programs previously funded by unrestricted title XX funds, resulting in little, if any, net increase in the level and quality of child care services. The information available on title XX expenditures by type of social service is too general to accurately measure the effect of the additional $200 million on the overall level of child care services.

Therefore, the deduction for child care expenses provides a direct subsidy for those who purchase child care services instead of receiving them free under title XX. HEW estimates that Federal AFDC expenses would have been approximately $84 million less in fiscal year 1977 if this deduction were not allowed.

Relationships Between the Tax Expenditure and Spending Programs

Rationale

The child care tax expenditure was changed from an itemized deduction to a tax credit by the Tax Reform Act of 1976. As an itemized deduction, the child care tax expenditure benefitted fewer lower income families, who generally use the standard deduction. At the same time, the prior law reduced the amount of expenses eligible for the deduction by one-half of adjusted gross income in excess of $35,000. This rule limited the amount of child care tax relief available to upper income taxpayers.

In changing the provision to a tax credit, Congress reasoned that child care expenses are a cost of earning income for which all working taxpayers should have a claim regardless of the level of their income or whether or not they itemize their personal expenses. Under the amended provision, taxpayers may claim a 20-percent credit against taxes for up to $2,000 in qualified child care expenses for one dependent or $4,000 for two or more dependents. The maximum credits available, therefore, are $400 and $800, respectively. The amount of child care expenses eligible for the 20-percent credit is limited to the earnings of the spouse with the lesser earnings. There are no family income limits on those who may claim the tax credit. This amended provision, Congress believed, would more adequately treat child care expenses as a cost of earning income, since it increases the amount of eligible child care expenses in relation to a taxpayer's earned income, while, except for full-time students,[3] limiting the credit to those who work.[4]

The rationale for the AFDC work expense allowance is primarily based on the treatment of child care expenses as a cost of (potentially) earning income. Like the child care tax credit, the program is not primarily intended to expand the level of child care.

The major child care spending programs, in contrast, are explicit Federal efforts to increase the level of these services available to low-income, needy families. Head Start, the child care food service program, and a large number of title XX grants all provide financial

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[3] Full-time students are also allowed to utilize the child care tax credit provisions, since Congress considered education a cost of earning future income. For tax credit purposes, students with one dependent are treated as if they earn $166 a month ($333 a month for two or more dependents).

[4] Changing the child care tax expenditure from an itemized deduction to an "above-the-line" tax deduction (which could be claimed by taxpayers regardless of whether or not they itemize) would, like the credit approach, have given all working taxpayers with tax liability and qualified expenses access to child care benefits. An above-the-line deduction is considered an adjustment to gross income, and is generally the appropriate tax accounting procedure for expenses incurred in the process of earning income. An unlimited deduction of this type would be a more technically proper way of treating child care expenses as a cost of earning income than the credit approach. Congress stated in its report on the 1976 tax revisions, however, that the disparity of benefits between high- and low-income taxpayers that would have resulted from an above-the-line deduction of this type made the tax credit a more equitable approach. Thus, while the stated purpose of the tax credit is to account more properly for the costs of earning income in computing tax liability, the choice of a limited credit over an unlimited "above-the line" deduction expresses as well the desire on the part of the Congress that the child care credit provide more equitable financial relief from the costs of child care to working parents across all income classes, and that it provide increased access to both home and institutional day care for low- and middle-income families.

support for expanded child care services serving low-income families. These programs also serve as forms of supplementary income assistance, since all are targeted, to some extent, to AFDC, medicaid, and SSI recipients.

To the extent that free or highly subsidized child care services offer persons presently receiving income assistance payments the opportunity to seek employment, these programs may encourage persons to work. However, in contrast to the tax expenditure, none of the major child care spending programs require that recipients be employed or full-time students to receive benefits. Only the AFDC work expense allowance, among all the spending programs, requires recipients to have earnings in order to receive benefits.

Distribution of Benefits

The child care tax expenditure and the spending programs generally benefit members of different income classes. Because the child care tax credit is nonrefundable (i.e., it may not exceed the amount of income tax otherwise due), it provides assistance only to those with tax liability, primarily middle and upper income households. On the other hand, the benefits from income-targeted programs like Head Start, child care food service, the AFDC work expense allowance, and title XX accrue mainly to lower income persons. The distribution of benefits under these programs is shown in the following table.

Percentage Distribution of Child Care Benefits by Type of Expenditure and by Income Class, Fiscal Year 1977

Income class [1] (thousands)	Tax expenditures [2]	Spending programs [3]
0 to $10	14	85
$10 to $20	43	15
$20 to $50	41	0
$50 and over	2	0

[1] The available tax expenditure distribution estimates are by expanded gross income class, while the spending program distribution estimates are by adjusted gross income class. Expanded income is a somewhat broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income. Significant differences from the use of these two standards exist, for the most part, only with respect to individuals with income in excess of $50,000. Taxpayers with income below $50,000 do not generally have significant amounts of tax preference income.

[2] Treasury Department estimates.

[3] Congressional Budget Office estimates.

Scope of Benefits

Child care tax expenditure benefits are distributed to more persons than are Federal spending program benefits. The total amount of tax expenditure benefits that support child care is limited only by the tax credit ceilings of $400 or $800 per taxpayer, by the costs of the services acquired, and by the number of eligible persons using the provision. As with all tax expenditures, the child care tax credit is available to all taxpayers who meet the requirements of the tax provision. In this sense, the credit is like an entitlement program; the total of all

benefits conferred is not subject to any legislative limit. Approximately 2.7 million taxpayers took advantage of the child care credit in calendar year 1976, resulting in subsidized child care service for approximately 4 million children.

By contrast, the number of persons who can receive benefits from the title XX program, Head Start, or the child care food service program is limited by specific appropriation levels. For example, no more than $2.5 billion in title XX funds [5] may be distributed annually on a State-by-State block grant basis. Furthermore, since title XX is a matching grant program (75 percent Federal support, 25 percent State and local support), the amount of available funds and the level of local child care services will in part be a function of each State's desire to initiate and fund such programs. As a result, local child care services financed with title XX funds are available to only a limited number of eligible families and are usually distributed on a first-come, first-serve basis, producing long waiting lists for many State programs and facilities. Thus, some low-income families without tax liability receive no Federal child care assistance from either tax expenditures or spending programs.

Approximately 800,000 children received child care services under title XX in fiscal year 1977; Head Start served approximately 359,000 children; and the child care food service program provided aid for approximately 580,000 children, most of whom also benefitted from the Head Start and title XX day care programs.

While child care spending programs benefit fewer persons than the related tax expenditure, participating families generally receive larger subsidies. The majority of families with income under $10,000 who participate in federally subsidized child care programs have nearly all of their child care expenses paid for by the Federal Government. Title XX services are usually free for families in this income class. The child care tax expenditure, on the other hand, can subsidize no more than 20 percent of a family's total child care expenses. As a result, the average value of the child care subsidy under title XX in fiscal year 1976 was $1,000 per child compared to an average child care tax credit of $170 per taxpayer.

Regional Effects

The child care tax expenditure is available to all taxpayers regardless of their place of residence. Spending programs, on the other hand, provide varying degrees of child care support depending upon the particular State and local community. The amount of child care food service and Head Start funds available in a community will depend upon both the number of potential public or nonprofit child care grant sponsors and the level of local support for child care programs.

Title XX funds are distributed among States on the basis of population. However, because funds are not earmarked for particular services (other than the $200 million supplementary appropriation for 1977–78), the proportion of funds that support child care as opposed to other social services varies widely among States. For instance,

[5] Excluding the additional $200 million for child care services provided under Public Law 94–401.

while Alabama spent approximately 25 percent of its title XX funds on child day care services in the quarter ending in June 1976, Missouri spent nearly half its title XX funds on child care during this period.[6]

Types and Quality of Child Care Service

The child care tax credit and the AFDC work expense allowance subsidize almost any type of child care service, including, under certain conditions, the hiring of relatives for in-home personal care. Day care services subsidized by the child care tax credit need not be licensed or provided through specific kinds of institutions; nor are quality standards imposed on services eligible for the credit.

By comparison, the Head Start and child care food service programs are, by definition, services provided by institutions that meet Federal and State standards. Title XX child care funds are allocated to several types of licensed facilities. For example, in the second quarter of 1976, 71 percent of title XX day care expenditures went to licensed institutional facilities serving 12 or more children; 16 percent supported family home day care, which provides service to a maximum of six children in an approved private family home; and 12 percent of the funds supported in-home day care centers, where children receive service in their homes by qualified persons other than their parents.[7]

State and local agencies that administer title XX child care programs generally have substantial control over the types of service available. As a result, the extent to which families may choose among competing forms of child care service varies from State to State. All child care services subsidized by title XX funds must be approved by the responsible State or local administrative agency.

As originally formulated, title XX legislation required that local grant recipients meet certain Federal child care staffing requirements based on the ages of the participating children. However, prior to the enactment of title XX in October 1975, several States complained that staffing regulations would be too expensive to implement and were an infringement on the rights of individual States to set their own social service quality standards. The effective date for title XX staffing standards has since been postponed several times and is currently under suspension pending the completion of an HEW evaluation study. Head Start and child care food service grant recipients are also subject to certain Federal quality standards. These standards have generally been enforced, since these programs are under direct Federal control and do not impose additional costs or planning constraints on State or local governments.

Overlap of Benefits

There is probably little overlap between child care tax expenditure and spending program coverage, since few families that receive highly subsidized or free child care under Federal spending programs require additional private sector services for which they may claim the child care tax credit. Moreover, relatively few of those who do incur additional private sector child care expenses are likely to have sufficient tax liability to benefit from the credit.

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[6] U.S. Department of Health, Education, and Welfare, *Social Services U.S.A.: April–June 1976*, Publication No. 77–03300, 1977, p. 46.

[7] *Social Services U.S.A.*, op. cit., p. 83.

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EMPLOYMENT PROGRAMS

Tax Expenditures

The "new jobs" tax credit, enacted on a temporary basis as part of the Tax Reduction and Simplification Act of 1977, provides employers with income tax credits in 1977 and 1978 for expanding their work force. This tax expenditure will result in estimated revenue losses of approximately $1.9 billion in fiscal year 1979,[1] compared to an estimated $14.7 billion in outlays for the major spending programs that have job creation as their principal purpose. A much smaller employment-related tax expenditure, expected to result in revenue losses of $20 million in fiscal 1979, is the tax credit for hiring individuals either previously enrolled in the work incentive program (WIN) or receiving assistance from the aid to families with dependent children program (AFDC) for at least 90 days. Tax expenditures aimed at job creation are described in greater detail on pages 125–130 in Part I of this compendium.

Spending Programs

Direct Government spending aimed at job creation was first used extensively in the 1930's to help alleviate the widespread unemployment of the Great Depression. In the 1960's, the focus of job creation policy shifted from the problem of national unemployment to the problem of structural unemployment caused both by industrial relocation and unequal regional growth rates, and by the inability of many unskilled individuals to find permanent or long-term employment. More recently, some employment programs have been used to provide countercyclical economic stimulus, although the focus of employment policies is expected to shift back to structural unemployment over the next several years as the national employment rate returns to pre-recession levels.

Existing Federal job creation programs can be classified under three general headings: public works, public service training and employment, and antirecession fiscal assistance. Outlays for the major Federal employment programs are listed in the following table.

[1] The new jobs tax credit will expire on Dec. 31, 1978. The estimated full-year cost of the credit is $2.5 billion.

Estimated Outlays for Employment

[In millions of dollars]

Program	1978	1979	1980
Public works:			
Local Public Works (Public Works Employment Act of 1976, title I)	2, 800	1, 920	620
Public Works and Economic Development Act, titles I and IX	233	244	318
Public service employment and training:			
Comprehensive Employment and Training Act:			
CETA titles II and VI (public service employment)	5, 382	5, 956	6, 649
CETA titles I and IV (manpower services)	1, 808	2, 375	2, 724
CETA titles III and VIII (special target groups)	2, 214	2, 906	3, 335
Work incentive program	365	385	431
Community service employment for older Americans	152	177	198
Antirecession fiscal assistance:			
Public Works Employment Act of 1976, title II	1, 373	740	------
Total	14, 327	14, 703	14, 275

PUBLIC WORKS

Public works employment programs provide grants to States and localities for the construction of new public facilities (schools, hospitals, sewer systems, etc.) and for capital improvements to existing public facilities (road repair, building maintenance, etc.). Projects funded by Federal public works employment programs are generally contracted to private firms, although some are directly organized by grant recipients. The major public works employment programs are authorized by Title I of the Public Works Employment Act of 1976 and by the Public Works and Economic Development Act of 1965. These two programs are briefly described below.

Local Public Works (Public Works Employment Act of 1976)

The Public Works Employment Act of 1976 authorizes public works grants for State and local governments that experience unusually high unemployment. Local public works funds have been allocated to State and local governments in two separate rounds of evaluation and consideration so far, with projects required to have begun within 90 days after funds were awarded.

Under round I, 70 percent of the funds were allocated to projects in areas with unemployment rates exceeding the national average (7.78 percent in the 3-month period during 1976 used for allocation data purposes). The remaining 30 percent were allocated to projects in areas with unemployment rates below the national average, with priority given to those jurisdictions with unemployment rates exceeding 6.5 percent.

Under round II, approximately 65 percent of the funds were allocated to States on the basis of their share of total unemployed persons in all States. The remaining funds were allocated to States on the basis of their unemployment rate relative to the national average. State shares of local public works funds were then distributed to cities and counties according to a similar 65/35 percent formula.

Nationally, $6 billion has been authorized and allocated under both rounds of the local public works program for projects which began between January 1977 and January 1978. Nearly 90 percent of the total outlays for these local public works projects will occur in fiscal years 1978–80.

Public Works and Economic Development Act of 1965

Public works grants authorized by the Public Works and Economic Development Act of 1965 are administered by the Economic Development Administration in the Department of Commerce. These grants are allocated to cities and States with: (1) high concentrations of low-income persons; (2) substantial rural out-migration; (3) substantial unemployment; or (4) an actual or threatened rise of unemployment attributable to the closing or curtailment of a major source of employment.

PUBLIC SERVICE EMPLOYMENT AND TRAINING

Public service employment programs provide short-term service jobs in the public sector and in private, nonprofit agencies for disadvantaged and unemployed persons during periods of high unemployment. Public training programs provide basic education, skill training, and part-time work experience. Although they often support valuable public services, the primary purpose of public service employment and training programs is to increase employment and employment opportunities for disadvantaged and unskilled population groups. The major programs are described below.

Comprehensive Employment and Training Act

The Comprehensive Employment and Training Act of 1973 (CETA) is the Federal Government's major public service employment and training program. CETA consolidates most of the education and manpower programs of the 1960's with more recent programs designed to stimulate employment in regions particularly hard hit by recession.

CETA funds are initially awarded, for the most part, to cities or counties (or combinations of the two) with populations exceeding 100,000. These jurisdictions then subcontract with local government agencies or nonprofit organizations for the planning and implementation of projects.

CETA TITLES II AND VI

CETA titles II and VI provide funds primarily for public service employment. In fiscal year 1976, 96 percent of the participants in CETA title II programs and 84 percent of the participants in title VI were placed in CETA-funded jobs. Title II funds are targeted to jurisdictions with at least a 6.5 percent unemployment rate for 3 consecu-

tive months. Ninety percent of title II funds must pay for wages, salaries, and employment benefits. All jobs must be filled by area residents, with preference given to those with the longest unemployment history. Jobs funded by CETA usually require a relatively low skill level and little capital input. Typical CETA-funded jobs are school maintenance aides, nurse aides, cashiers, typists, and day-care aides.

Title VI, currently the largest CETA program, augments the number of public service jobs available under title II during periods of excessive unemployment. Eligibility requirements for title VI program participants are somewhat stricter than under title II, and allocation formulas are more narrowly targeted to those jurisdictions experiencing the greatest unemployment. Almost half of all CETA funds in fiscal year 1977 were allocated under titles II and VI for public service employment. Participants in title II and title VI programs tend to reflect the more general demographic characteristics of the unemployed labor force, as compared to the participants in the other CETA programs, which are more narrowly targeted to disadvantaged population groups.

CETA TITLES I AND IV

CETA titles I and IV establish nationwide employment and training programs that teach job skills. These programs provide employment counseling, testing, referral, classroom training, on-the-job training, and work experience for low-income, long-term unemployed workers.

Title I funds are allocated according to formulas based on previous year program allocations, the proportion of the national unemployed within the program sponsor's jurisdiction, and a measure of adult income level within the jurisdiction. The bulk of title I funding supports work experience programs that primarily provide temporary, part-time employment for youth and older workers.

The Job Corps (title IV) provides training and basic education to low-income, unemployed young people through a national system of 60 federally operated residential centers. Participants receive room and board, clothing, educational supplies, and a small cash allowance for up to 2 years. Upon leaving the center, participants are given assistance in finding employment.

CETA TITLES III AND VIII

Several other CETA programs provide public service employment for population groups that experience particularly high levels of unemployment. The most significant of these are the Young Adult Conservation Corps (title VIII), which offers conservation, wildlife, and recreation work to disadvantaged youth ages 16 to 23, and several sections of title III, which support summer jobs and additional educational and employment assistance for young people.

Work Incentive Program and Community Service Employment for Older Americans

Several programs other than CETA provide significant public service employment and training for groups with particularly high rates of unemployment. The work incentive program (WIN) provides

training, counseling, social services, and work experience to recipients of aid to families with dependent children (AFDC), while the community service program subsidizes part-time employment for unemployed, low-income persons age 55 and older.

ANTIRECESSION FISCAL ASSISTANCE

Title II of the Public Works Employment Act of 1976 authorizes targeted revenue sharing payments during periods of recession for States and localities experiencing high unemployment. In contrast to public service employment programs, the so-called "countercyclical" revenue sharing program is not intended to create new public sector jobs. Rather, its purpose is to help stabilize existing State and local government employment levels and maintain basic government services in danger of cutback or termination. With greater budgetary resources made possible by this program, State and local governments are better able to offset the shrinking tax revenues that often result from the lower level of economic activity in the private sector during a recession.

Antirecession fiscal assistance funds become available when the national unemployment rate reaches 6 percent; additional funds are released with each one-tenth percentage point increase above that level. A jurisdiction must have an unemployment rate exceeding 4.5 percent to qualify for assistance, with its entitlement based on the relative size of its general revenue sharing payment and on the amount its unemployment rate exceeds the 4.5 percent minimum.

Relationships Between the Tax Expenditures and Spending Programs [2]

Public vs. Private Sector Employment Programs

Federal efforts aimed at job creation employ either a public or private sector approach. The new jobs tax credit and the WIN and AFDC tax credits all work through the private sector. By lowering the cost to businesses of hiring additional workers, these tax expenditures are intended to stimulate the demand for labor in the private sector, thereby creating new jobs.

The public service employment and antirecession fiscal assistance programs, in contrast to the tax expenditures, work primarily through the public sector, either by increasing or maintaining the number of jobs in State and local government or by providing Federal grants for short-term public service projects.

Public works programs are primarily private sector oriented. Local construction firms are hired by State and local agencies to build specified capital projects, creating jobs in the private construction industry. Goods and services are purchased from the private sector for public use. On the other hand, public works programs may be considered public sector programs to the extent they require government bureaucracies to analyze project proposals and allocate funds.

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[2] Because the new jobs tax credit accounts for 99 percent of all revenue losses of the two employment tax expenditures, this section focuses primarily on comparing it to the various direct spending programs.

The distinction between private and public sector employment programs is significant for several reasons. The transition to permanent, unsubsidized employment is often a more formidable task for participants in public sector programs than for those hired in the private sector. Although most public sector programs provide training, work experience, or employment for short periods of time, participants usually must find permanent employment in the private sector when the subsidy programs terminate.

In contrast, workers hired by private firms utilizing the new jobs tax credit are more likely to remain in their jobs if the firm is relatively profitable and the economy is expanding. Construction workers employed by firms building public works projects are also less likely to face difficult transition problems if the construction industry experiences relative economic health.

Private sector employment programs are less likely to distort production decisions and misallocate resources than are those operated in the public sector. Since private sector firms remain subject to the profit constraints of the market, those receiving Federal subsidies from the new jobs tax credit must continue to make marketing, financial, product, and service decisions with respect to existing market conditions and the anticipated actions of competing firms. Public works employers are, in theory, subject to the same profit constraints as construction firms contracted by the private sector: construction firms generally present bids for large public sector capital projects in a manner similar to that used in awarding private sector contracts.

Public sector employers, on the other hand, are not subject to this type of strict market test. State and local governments and social service agencies are less restricted in their allocation of public service funds and subsidized employees among competing uses.

Public sector job creation programs also result in some expansion of government bureaucracy. These spending programs are appropriated a limited amount of funds, which must be budgeted and administered according to eligibility requirements, targeting procedures, and other specific program provisions.

Private sector tax credit programs generally result in more decentralized decisionmaking in hiring than their public sector counterparts. No large-scale organization or implementation plans are required. Hiring decisions are made at the company or plant level without consultation with government or other firms. However, private sector tax programs necessitate some expansion of the Internal Revenue Service bureaucracy to audit and adequately enforce the rules applying to the tax programs' provisions.

Distribution of Benefits

REGIONAL DISTRIBUTION EFFECTS

A major difference between the employment tax credit and direct spending job programs is in their contrasting regional effects. The current new jobs tax expenditure is structured as an incremental credit, allowing firms to credit against their total tax liability 50

percent of the amount that qualifying wages paid in a given year exceed 102 percent of the prior year's qualifying wages. As a result, the benefits of this tax expenditure flow to firms with relatively high rates of growth. These firms tend to be located in expanding regions with relatively low unemployment in the Southwest and West, and in the suburbs rather than central areas of major cities.

Spending programs, by contrast, tend to concentrate their benefits in urban centers with limited growth and declining populations. Therefore, in contrast to targeted employment spending programs, the new jobs tax credit provides relatively fewer benefits to declining regions most in need of job creation stimulus.

BUSINESS, STATE, AND LOCAL GOVERNMENT BENEFICIARIES

State and local governments and public service agencies are the major direct beneficiaries of public service employment and anti-recession fiscal assistance program benefits. These spending programs also directly benefit firms that supply materials, equipment, and other support to program sponsors and State and local government agencies. The building and construction industries are the primary direct beneficiaries of public works aid.

The Public Works Employment Act of 1976 requires that 10 percent of the funds allocated under the local public works program (title I) go to minority contractors or businesses. Commerce Department figures show that minority firms have received 15 percent of the funds that have been awarded to date under this program.

The availability and use of the new jobs tax credit depends primarily on the size of a firm's taxable income and its growth rate. Since the credit is nonrefundable, firms without tax liability for a sustained period, whether due to low profits or other tax preferences, cannot claim the credit.[3] Such firms tend to be those with large capital consumption allowances resulting from rapid growth, those in presently unprofitable industries such as railroads and steel, and firms already enjoying substantial tax preferences, such as those in the extractive industries.

The new jobs tax credit also favors labor-intensive over capital-intensive industries, particularly those labor-intensive firms paying relatively low wages. Because the base on which the credit is calculated is limited to the first $4,200 of employee wages, salary increases above this level have no effect on a firm's total credit. By hiring a large number of employees at relatively low wage levels, a firm can increase its tax credit for the same overall level of salary payments.

The $100,000 ceiling on the amount of the credit available in any given year limits the benefits and incentive effects of the employment tax credit for large firms. The ceiling, in effect, restricts the tax subsidy to 47 new, full-time, full-year employees per company, thereby excluding 3,000 large firms, which provide 35 percent of the nation's jobs, from the full incentive effects of the credit. While these firms will qualify for the maximum $100,000 credit, they will have no incentive to increase their employment above 47 new, full-time employees.

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[3] Unused new jobs tax credits can be carried back 3 years and then carried forward 7 years to offset tax liability occurring in any of these years.

At the same time, the experience of the WIN and AFDC tax expenditures indicates that small firms without professional assistance are often deterred from utilizing employment tax credits by the complexity of the provisions and the degree of required paperwork. Therefore, the new jobs tax credit may also be under-utilized by small businesses.

INDIVIDUAL BENEFICIARIES

Participants in CETA public service employment programs (titles II and VI) are somewhat older, better educated, and less economically disadvantaged than are the participants in the other CETA programs. In fiscal year 1977, 64 percent of the participants in CETA public service employment programs were between the ages of 22 and 44; 78 percent of the title II participants and 73 percent of the title VI participants had 12 or more years of schooling; 49 percent of the participants in title II were from economically disadvantaged families, while 67 percent of the title VI participants were economically disadvantaged.[4]

In contrast to titles II and VI, the other CETA programs are more narrowly targeted to young, minority, less educated, and economically disadvantaged population groups. For example, over half of all title I participants were less than 22 years old in fiscal 1977, and just under half had less than 12 years of education. Over 78 percent of the participants were economically disadvantaged.[5]

Job Corps (title IV) participants are required to be between 16 and 21 years old; 54 percent of the participants in the Job Corps program in 1977 were black, 85 percent had less than a high school education, and 70 percent were from families either receiving public assistance or earning less than $5,000 per year.[6] Other specially targeted CETA programs benefit young and old workers, American Indians, and migrant farmworkers.

Workers hired for construction projects funded by public works programs tend to be more highly skilled than those employed under CETA programs. However, capital projects funded by the local public works program are chosen partly on the basis of the projects' labor costs compared to their total costs, with priority given to those with the highest percentage of labor costs. As a result, public works projects tend to employ, on average, more workers (and, generally, a larger percentage of lesser-skilled workers) than construction projects funded by the private sector.

No data are available regarding the economic and demographic characteristics of those hired under the recently enacted new jobs tax credit. However, its provisions provide some indications of the types of employees likely to be hired under the program. Aside from the additional 10 percent credit for employing the handicapped, the tax credit is an untargeted program that applies to the hiring of any type of employee. As a result, workers benefiting from the credit will most

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[4] U.S. Department of Labor, *Employment and Training Report of the President*, 1978, p. 42. The determination of "economically disadvantaged" is based, in part, on whether the participant was a member of a family whose annual income in relation to family size and location did not exceed either the most recently established poverty levels as determined by the Office of Management and Budget or 70 percent of the Bureau of Labor Statistics lower living standard income level—whichever is higher.

[5] *Ibid.*

[6] *Ibid.*, p. 50.

likely reflect the general demographic composition of the available labor force.

However, since the credit does not affect competition among different groups of potential workers (e.g., long-term vs. short-term unemployed, minority vs. non-minority), firms will tend to hire the most highly skilled workers available. Thus, the credit will subsidize a greater number of jobs for relatively higher skilled workers, perhaps laid off as a result of short-term employment fluctuations, than for long-term, lesser skilled, structurally unemployed persons. At the same time, however, the ceiling that limits the credit base to the first $4,200 of wages theoretically makes lower paid, unskilled, and part-time workers [7] more attractive to potential employers in terms of credit per dollar of wages paid.

Persons whose employment qualifies their employers for the WIN and AFDC tax credits are present and former recipients of AFDC benefits, the majority of whom are low-income women with less than a high school education.

Efficiency

Programs differ in the number of jobs they create per dollar of Federal outlay depending upon: (1) the percentage of a worker's total wages subsidized by the Federal funds; (2) the degree to which program benefits are targeted to employees who otherwise would not be hired; (3) the percentage of funds used for wage and salary costs as opposed to capital costs; (4) the average wage level of program participants; and (5) the extent to which the programs reduce Federal payments to persons receiving Federal income assistance.

VALUE OF EMPLOYMENT PROGRAM SUBSIDIES

The CETA and antirecession fiscal assistance programs generally subsidize 100 percent of the wages of employees hired under these programs, while public works sponsors are reimbursed for between 75 and 100 percent of their wage costs. In contrast, the maximum subsidy provided by the new jobs tax credit is between $603 and $1,806 per employee, depending upon the marginal tax rate of the employer. This translates into a saving of only 5.9 to 17.7 percent of estimated average employee earnings.[8] For a corporation with the general 48 percent marginal tax rate, the value of the credit per eligible employee is $1,092.[9] For a worker hired by such a corporation at the minimum wage, however, the tax credit provides a subsidy of 19.8 percent of total wages, while the subsidy will be even higher for new, part-time workers. In general, the greater the subsidy value per employee, the more likely the program is to stimulate a net

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[7] In addition to the 102 percent FUTA wage base ceiling, employers are only allowed credit on wages exceeding 105 percent of the previous year's *total* wage base. This provision limits, to some extent, the substitution of full-time for part-time workers.

[8] Average weekly employee earnings (average weekly earnings of production or nonsupervision workers on private nonagricultural payrolls) were estimated by the Bureau of Labor Statistics for December 1977 to be $196.75.

[9] The net value of the credit per employee is equal to the gross value of the credit—50 percent of the first $4,200 of wages—minus the corporation's additional income tax liability resulting from the requirement that the amount of the credit be subtracted from the firm's regular tax deduction for wages. Therefore:

Net value = Gross value minus additional taxes due to lower deduction
= $2,100 minus (48% × $2,100)
= $2,100 minus ($1,008)
= $1,092

increase in employment. While the new jobs tax credit costs less for each new employee hired, its subsidy value may be so low as to have little, if any, effect on many hiring decisions.

TARGETING TO INCREASE TOTAL EMPLOYMENT

The cost effectiveness of job creation programs is also in large measure dependent on the degree to which funds can be targeted to employees who otherwise would not be hired, thereby producing a net increase in the level of employment. Congress attempted to increase the effectiveness of the new jobs tax credit in this fashion by targeting it to "incremental employment," defined as the increase in the employer's Federal Unemployment Tax Act (FUTA) wage base above 102 percent of the previous year's level.

Although this formula eliminates some of the more serious problems of an untargeted tax credit applying to the wages of all employees, it still fails to adjust for the wide range of growth rates across individual firms, industries, and regions. Indeed, it is not unusual for the growth in the FUTA wage base for expanding firms to exceed 102 percent of the previous year's level, resulting in tax credits for substantial numbers of new employees who would have been hired anyway.

Direct spending employment programs may also subsidize nonincremental employment, resulting in so-called "fiscal substitution." In the context of public service employment programs, fiscal substitution refers to the use of Federal funds to pay current employees, to maintain current services, or to hire employees who would have been hired in the absence of the program. In the context of antirecession assistance, it is the substitution of Federal funds for non-Federal funds, leading to a net reduction in taxes or retirement of debt. While most agencies that administer public service employment and antirecession fiscal assistance programs have "maintenance of effort" provisions which forbid these practices, existing evidence suggests that these provisions have not been very successful over the long run.

For example, one recent study of the effectiveness of public service employment programs found that fiscal substitution increases substantially with the length of time a program is in effect, implying that employment program grants are relatively ineffective when State and local governments have time to integrate them into their budgets. The study suggests, however, that such grants can be an effective short-run countercyclical tool when unanticipated by potential sponsors.[10]

Another study found that unanticipated short-run employment grants to State and local governments may be a primary cause of the large growth in State and local budget surpluses over the last several years. Without adequate advance planning, it is argued, State and local governments are unable to spend program funds when they are received, resulting in large increases in budget surpluses and only marginal changes in budget expenditure levels.[11]

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[10] George E. Johnson and James D. Tomola, "The Fiscal Substitution Effects of Alternative Approaches to Public Service Employment Policy," *Journal of Human Resources*, Winter 1977, p. 19.

[11] Edward M. Gramlich, "State and Local Budgets the Day After It Rained: Why Is the Surplus So High?" *Brookings Papers on Economic Activity*, Vol. 1, 1978, pp. 191–216, and especially table 3, p. 202, and table 5, p. 210.

Antirecession fiscal assistance programs have not been in effect long enough to determine on the basis of program data the degree to which their impact has been dulled by fiscal substitution. However, the Gramlich study cited above, which estimated the response of State and local government expenditures and tax collections to untied government grants similar to those provided under the antirecession fiscal assistance program, concluded that untied grants primarily result in reductions in State and local tax revenues, with little change in budget expenditure levels. In the long run, the study estimated that $1 in untied aid is likely to stimulate only a $0.16 net increase in State and local government expenditures, but a net reduction in tax revenues of $0.84.

The study also estimated the probable effects the antirecession fiscal assistance program would have had were it in effect during the 1974–77 recessionary period. The estimates suggest that antirecession fiscal assistance payments primarily would have supported increases in State and local government budget surpluses, with some reduction in tax revenues and only a minimal change in expenditure levels. According to this study, between 1974 and 1977, State and local government assets would have increased by approximately $4.2 billion, tax revenues would have decreased by approximately $1.9 billion, and expenditures would have increased by only $325 million had the current antirecession fiscal assistance program been in effect during this period.[12]

WAGE LEVELS AND LABOR INTENSIVENESS

The amount of program expenditures supporting labor as opposed to capital costs is another factor contributing to the effectiveness of employment programs. Programs that allocate a high percentage of expenditures for labor costs create more jobs per dollar of budget outlay. Between 80 and 90 percent of CETA funds are generally required to pay for wages and salaries, a relatively high percentage of labor expenditures compared to the percentage under public works projects, which require far greater capital outlays for each employee hired.

In addition, the general wage level of subsidized employees will affect a program's efficiency as an employment mechanism. Public service jobs under CETA are aimed at relatively unskilled workers and the long-term unemployed, and therefore pay relatively low wages. Public works projects, on the other hand, usually require skilled construction workers who command much higher salaries as do the generally higher skilled government workers funded by antirecession fiscal assistance payments. The new jobs tax credit applies to new employees in all types of businesses offering a wide range of salary levels. However, the credit wage base of $4,200 places a relatively low limit on the maximum credit per new employee regardless of the employee's wage level.

Differences in the percentage of total expenditures that support labor costs compared to capital costs and in the general wage level of participants produce a wide variation in the average cost per job

[12] *Ibid.*

under different types of employment programs. For example, a 1975 Congressional Budget Office study determined the average annual expenditure per job under Title VI of CETA to be approximately $8,000, whereas the cost per worker-year for new public works construction averaged $35,524.[13] The new jobs tax credit subsidizes jobs at an apparent annual cost of between $603 and $1,806 per worker, depending upon the marginal tax rate of the employer. However, cost estimates of this type fail to take into account the degree to which program expenditures subsidize workers who would have been hired in the program's absence. One recent study, for example, estimated that as much as three-fourths of all new jobs tax credits may have resulted in "windfall" benefits without producing a net increase in the number of employees.[14] In that case, the actual cost per job subsidized would be about four times the tax benefit, or $2,400 to $7,200 per worker.

Although public works jobs are probably the most costly way of creating employment, advocates argue that capital projects funded by public works programs (buildings, dams, road repairs, etc.) are more valuable and lasting than the services provided by public service employment and training programs. In addition, major public works projects are more likely than public service employment or anti-recession fiscal assistance programs to stimulate long-run, private sector employment by inducing local industrial development.

OFFSETTING REDUCTIONS IN FEDERAL OUTLAYS

The number of jobs created per dollar of budget outlay is increased when employment programs hire persons receiving some form of Federal income assistance. Many CETA programs are targeted to population groups with extremely high unemployment, as are the WIN and AFDC tax expenditures. These programs, therefore, cost less in terms of net Federal expenditures than their gross outlay cost because they tend to reduce the drain on direct government income assistance programs. A recent General Accounting Office report estimated that 20 percent of CETA Title VI jobholders in September 1976 previously had been receiving either AFDC or unemployment payments; approximately 35 percent of those hired since September 1976 (when program eligibility requirements were tightened) previously had been receiving some form of Federal income assistance.[15]

The effects of the new jobs tax credit, public works, and the anti-recession fiscal assistance programs on net Federal expenditures is unclear and difficult to measure. In contrast to the CETA programs, little data has been collected on the characteristics of persons hired under these employment programs. Some conjectures regarding the extent to which these programs reduce Federal unemployment compensation and assistance payments can be made, however, on the basis of the programs' provisions and the employment sectors in which they operate.

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[13] Congressional Budget Office, *Temporary Measures To Stimulate Employment*, September 1975, pp. 19–20, 35.

[14] U.S. Bureau of the Census, "New Jobs Tax Credit Survey," conducted for the U.S. Department of Labor, April 1978.

[15] U.S. General Accounting Office, *Information on the Buildup in Public Service Jobs*, Report by the Comptroller General of the United States, HRD-78-57, Mar. 6, 1978, p. 2.

Antirecession fiscal assistance payments are not intended to subsidize new jobs, but rather to maintain existing employment levels in State and municipal governments. To the extent that these funds subsidize workers who would otherwise be laid off, and who would then presumably collect unemployment compensation, antirecession fiscal assistance may reduce Federal unemployment compensation outlays.

To the extent that skilled and experienced construction workers hired for public works projects tend to collect substantial unemployment benefits as a result of the highly cyclical nature of the industry and the workers' relatively high wage levels, public works programs may also reduce Federal unemployment compensation outlays below what they would be otherwise. Similarly, during periods of high unemployment, firms utilizing the new jobs tax credit may rehire recently laid off workers collecting unemployment compensation payments, thereby reducing the credit's net cost per dollar of Federal revenue loss. However, none of these three programs is targeted to long-term, structurally unemployed population groups, which tend to collect a substantial portion of Federal income assistance payments. Thus, these programs probably have less of an effect on reducing Federal assistance payments than the targeted CETA programs.

Speed of Job Creation

The ability to create jobs quickly is essential when the goal of a program is to counteract short-term recession. Public works programs are considered the least flexible employment mechanism in this regard, and are therefore thought better suited to counter long-term unemployment. Workers cannot be hired under public works programs until materials and equipment have been purchased, project sites approved, and contracts negotiated. Indeed, one study cited above found that so far, the principal effect of the local public works program, which was intended to stimulate employment during 1976 and 1977, has been to create large State and local budget surpluses, in part because of the long leadtime necessary to evaluate and plan projects before the bulk of the funds can be spent.[16]

Most studies indicate that public service employment and antirecession fiscal assistance programs create jobs more quickly than public works programs, and are therefore better suited for use as countercyclical tools. Often, public service employment funds simply increase hiring in already existing programs. Similarly, antirecession fiscal assistance funds are intended to support jobs already in existence, although, as noted earlier, such funds may simply result in large State and local budget surpluses and no net employment effect.

The extent to which an employment tax credit can be used as an effective countercyclical job stimulus tool is unclear given the relative lack of experience with this type of program. There is no evidence regarding the speed with which the new jobs tax credit enacted in 1977 has affected business employment decisions. In theory, the credit should act relatively quickly compared to public works or public service programs since no administrative planning is necessary. All

[16] Edward M. Gramlich, *op. cit.*

employment decisions regarding the new jobs tax credit are made at the company level in the private sector.

It appears from the provisions of the current credit, however, that it was not primarily intended as a countercyclical program, although its passage in 1977 was prompted to some extent by high unemployment rates existing at the time and, therefore, the need for additional employment stimulus. The amount of tax savings provided employers by the credit is not tied in any way to the level of national unemployment, and the credit is available for 1977 and 1978 regardless of the employment rates in those years.

If the employment tax credit is viewed as a general employment stimulus program rather than as a countercyclical program (as its provisions suggest), and if it is extended as permanent legislation, then the speed with which it creates jobs is no longer significant. However, as permanent legislation, the new jobs credit would act in a procyclical fashion. That is, firms would utilize the credit less when the demand for their products slackens during a recession, yet would receive the full benefits of its provisions by hiring new employees during periods of economic expansion.

Inflationary Effects

Programs that increase demand for scarce resources tend to exert inflationary pressure. Outlays for employment programs targeted to regions and population groups with high levels of unemployment are therefore less likely to generate inflationary pressures than are more general programs because the supply of idle labor and resources in these areas is greater. Public works construction projects requiring capital goods and scarce skilled labor run a much greater risk of fueling inflation, in part because of the greater demand for skilled employees and in part because of the rapid rise in building costs in recent years.

Proponents of the new jobs credit argue that, because it results in lower labor costs, the credit will exert downward pressure on prices, thereby moderating the rate of inflation in the economy. In addition, the credit base ceiling of $4,200, as stated above, provides an incentive to hire lower paid workers who are in greater supply. On the other hand, the new jobs credit may be inflationary as a result of its regional bias favoring high growth areas.[17] High growth areas are generally more susceptible to both wage and price inflation than are economically stable or declining areas, which receive most job creation outlays.

Administration

Advocates of private sector employment tax credits argue that the administrative costs of such programs are far less than those associated with job creation spending programs. "Maintenance of effort" provisions in public employment and antirecession fiscal assistance programs, it is argued, are difficult to administer. Moreover, the review and evaluation of public works project proposals and potential public service sponsors, which often require detailed study of budgets, revenue statements, and contract plans, can be quite expensive.

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[17] See discussion of regional distribution effects, pp. 296–297, *supra*.

In contrast to the spending programs, supporters of the new jobs tax credit point out that most information necessary to determine the employer's credit is already reported to the IRS. Others contend, however, that the cost to the Federal Government of effectively enforcing the provisions of the credit could be substantial. A widely available tax expenditure of this magnitude, they assert, requires a significant IRS auditing effort to prevent losses due to misinterpretation and fraud.[18]

Legislative Initiatives

The new jobs tax credit, scheduled to expire at the end of 1978, is being considered for renewal by the present Congress. A number of targeted job credits have been suggested as alternatives to the expiring new jobs tax credit. In general, these proposals would substitute a tax credit targeted to low-income young persons, handicapped persons, and other disadvantaged groups. The amount of the credit under the proposals would be based, like the existing credit, on a percentage of eligible employee wages subject to the Federal unemployment tax (FUTA), up to a specified per employee limit.

However, the $100,000 credit ceiling, which limits the incentive effects of the present tax credit for large companies, would be eliminated. In addition, the 102 percent FUTA incremental base, which limits the present credit to firms with employment growth, would also be eliminated, thereby reducing the pro-cyclical effects of the present credit, and making the incentive available to companies struggling to maintain their existing employment levels.

A targeted jobs credit of this type would provide an incentive for all firms, regardless of their size or employment growth rate, to hire low-income young persons and handicapped persons. By comparison, the existing tax credit is available to limited classes of employers (based on size and recent growth history) to hire all types of employees.

The Senate passed in August 1978 a bill reauthorizing CETA through 1982. The House is currently developing a similar reauthorization bill. Both the House and Senate legislation reflect Congressional efforts to target CETA programs more closely to the structurally unemployed and to curtail fiscal substitution in public service employment programs. Although the final form of the reauthorization legislation is unclear at this time, there is sentiment in both Houses to tie the level of CETA funding in some fashion to the national unemployment rate. By making CETA public service employment funds available on the basis of the unemployment rate ("triggering"), CETA countercyclical employment programs would automatically be phased out as the unemployment rate is reduced.

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[18] In particular, some provisions of the credit, such as the various credit limitation calculations and the special rules applicable to controlled businesses, business ownership transfers, tax-option corporations, estates, trusts, and banks, are complicated and may be difficult to apply and administer.

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HEALTH

Tax Expenditures

Health care tax expenditures encourage the purchase of commercial health insurance and lessen the financial impact of relatively high, unreimbursed medical expenses. The two major health care tax expenditures are: (1) the exclusion from employee income of employer contributions for medical insurance premiums and medical care; and (2) the deductibility of medical care costs in excess of 3 percent of adjusted gross income, including prescription drug and pharmaceutical expenses in excess of 1 percent of adjusted gross income and a portion of health insurance premiums paid by individual taxpayers.[1] These two health care tax expenditures account for 90 percent of all Federal tax expenditure aid associated with health.

In addition, taxpayers are encouraged to support hospitals, hospital building funds, charitable health organizations, and health research institutions by the tax expenditure allowing charitable contributions to be deducted from taxable income. Finally, State and municipal governments receive substantial tax expenditure aid for hospital construction and rehabilitation from the tax expenditure excluding interest on State and local bond debt from taxable income.[2]

Total health tax expenditures will result in revenue losses of approximately $11 billion in fiscal year 1979, about 16 percent of total tax and direct Federal spending for health.[3] Health tax expenditures are described and analyzed in greater detail on pages 117–119 and 131–134 in Part I of this compendium.

Spending Programs

Federal outlays for health are expected to total approximately $57 billion in fiscal year 1979, approximately 11 percent of the total Federal budget. This sum will account for about 28 percent of all public and private health expenditures in the United States. Federal outlays for health-related programs can be divided into 3 general categories: the provision of health care services, the development of health resources, and the promotion of consumer and occupational health and safety. The estimated budget outlays for health programs are presented in the following table.

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[1] One-half of personal health insurance premiums up to $150 may be deducted without regard to the 3 percent minimum floor by taxpayers who itemize deductions. The other half may be included as an eligible expense in calculating total medical care costs subject to the 3 percent requirement.

[2] The tax expenditure excluding interest on State and local debt from taxable income is discussed in greater detail on pp. 347–358 in the section on general purpose fiscal assistance tax expenditures and related spending programs.

[3] Estimate does not include the tax exemption for State and local debt to the extent it supports hospital construction.

Estimated Outlays for Health

[In millions of dollars]

Program	1978	1979	1980
Provision of health care services:			
Medicare	25, 798	29, 263	34, 362
Medicaid	10, 864	11, 787	12, 721
Veterans	5, 300	5, 800	6, 200
Military personnel and dependents	1, 500	1, 600	1, 700
Other	2, 715	3, 559	3, 949
Development of health resources:			
Health research	2, 712	2, 977	3, 183
Training and education	756	843	931
Construction	39	44	47
Health planning and statistics	268	225	214
Consumer and occupational health and safety:			
Consumer safety	562	607	665
Occupational health and safety	241	214	230
Total	50, 755	56, 919	64, 202

HEALTH CARE SERVICE PROGRAMS

Health care service programs, which account for approximately 90 percent of total Federal health outlays, are generally targeted to particular population groups. Medicare and medicaid expenditures, accounting for over two-thirds of all Federal health program outlays, support medical services for the poor, aged, and disabled. The Federal Government also provides or finances medical care for military personnel and their dependents and for veterans. Spending programs for American Indians, Alaskan natives, and migrant farm workers provide funds for health care and the construction of medical facilities. Other health care service programs fund such diverse activities as drug abuse treatment, mental health treatment, lead paint poisoning prevention, and rat control programs. The major health service programs are described below.

Medicare

Medicare, the national health insurance program, was enacted in 1965. Adminstered by the Medicare Bureau of the Health Care Financing Administration, medicare reduces the out-of-pocket cost of medical care for the aged and disabled.

The medicare program provides hospital insurance (HI) and supplementary medical insurance (SMI). HI provides basic protection against the costs of inpatient hospital care, inpatient laboratory and X-ray services, skilled nursing home care, and home health care after hospitalization. SMI affords protection against the costs of physician services, outpatient laboratory and diagnostic services, medical supplies, and home health care. Medicare beneficiaries are automatically enrolled in both programs, but may thereafter decline SMI coverage.

Eligibility for the hospital insurance portion of medicare is not income-tested, but rather determined by eligibility for social security or railroad retirement benefits. Eligible persons include those who

are 65 years of age or older and receiving social security or railroad retirement benefits, disabled persons under 65 years of age who have been entitled to social security disability payments for at least 2 consecutive years, and persons suffering from chronic kidney disease. Persons over 65 and ineligible for social security or railroad retirement benefits may enroll in the medicare program by paying a monthly premium, currently $63 for hospital insurance and $8.20 for supplementary medical insurance.

The medicare hospital insurance program is financed from a social security trust fund. Supplementary medical insurance is jointly financed by monthly premiums paid by the insured individuals, and from general Treasury revenues.

Like many private health insurance plans, the medicare program requires a beneficiary to meet specified deductible and cost-sharing requirements for certain services under both HI and SMI irrespective of the size of the beneficiary's income.

Annual outlays for medicare have grown from $3.4 billion in 1967 to $21.4 billion in 1977. Approximately 25 million individuals were covered under medicare hospital and supplementary medical insurance in 1977, while over 14 million persons received medicare payments.

Medicaid

Established by the 1965 Social Security Act Amendments, medicaid is a joint Federal-State income-tested program of medical assistance for low-income and medically needy persons. Eligibility requirements vary among States, but follow three general classifications: (1) income assistance—Federal law requires that State medicaid programs cover all persons eligible for benefits under the aid to families with dependent children program; (2) categorical eligibility—most States provide medicaid coverage for elderly, blind, and disabled individuals eligible for benefits under the supplemental security income (SSI) program, although State categorical eligibility may be somewhat stricter than Federal SSI requirements; and (3) medically needy persons—States may offer individuals not eligible for full medicaid coverage under the income assistance or categorical tests partial reimbursement for medical services calculated on the difference between the recipient's annual income and the income assistance eligibility ceiling.

All States except Arizona currently participate in the medicaid program, but the level and scope of benefits offered vary from State to State. While all programs must cover certain basic medical services, States are free to offer additional services, as well as to exert some influence on their particular program's scope of coverage, level of benefits, and any copayment requirements.

States receive Federal medicaid funds on a matching expenditure basis according to a formula based on State per capita income. The matching percentage of Federal payments is at least 50 percent and increases the lower the State per capita income level. However, per capita Federal spending is generally higher in States with higher income levels, as these States generally have higher medicaid benefit levels and more liberal eligibility requirements.

Medicaid recipients may also receive medicare payments if they are eligible. In such cases, medicaid generally pays medicare premiums,

deductibles, and copayments, and for services not covered under medicare.

DEVELOPMENT OF HEALTH RESOURCES

Health resource programs are intended to advance medical knowledge, improve medical practice, and increase the supply of health professionals and medical facilities. Program benefits are not targeted toward particular groups in the population. Approximately 7 percent of all Federal health outlays support health resource programs for research, training, and education of health professionals, construction and modernization of hospitals and other medical facilities, collection and analysis of health statistics, and health planning.

CONSUMER AND OCCUPATIONAL HEALTH AND SAFETY

Consumer and occupational health and safety programs, which account for less than 2 percent of Federal health spending, support such activities as product testing, inspection of premises, and the development of health and safety standards.

Relationships Between the Tax Expenditures and Spending Programs

Rationale

Health care spending programs are intended to expand the availability of medical services by substantially decreasing their costs for blind, disabled, elderly, and low-income individuals who cannot normally afford adequate medical care. The exclusion from taxable income of employer contributions for medical insurance premiums and medical care and the deduction of one-half of personal insurance premiums up to $150 per year subsidize the purchase of private health insurance.

The deduction for medical expenses in excess of 3 percent of adjusted gross income provides financial relief to families experiencing relatively high health expenses not covered by a public or private medical plan. Although the medical expense deduction may induce some upper income taxpayers in high marginal tax brackets to increase their personal medical expenditures, it is not primarily intended to increase the availability of health care.

Distribution of Benefits

Outlays for health care services are targeted to well-defined population groups. Medicare, the largest single health care program, benefits elderly, retired, and disabled persons. Although medicare benefits are not explicitly income-tested, most recipients are in the lower income classes. Medicaid, the other major health service program, provides medical services to blind, elderly, disabled, and low-income persons on the basis of State eligibility tests.

The following table shows the distribution by age and income class of Federal outlays for health care services. The data illustrate that, while the nonpoor U.S. population received more in total assistance for health services than the poor population, per capita expenditures were higher for the poor. Irrespective of income status, the aged are the

beneficiaries of just over half of all health care service outlays, although they comprise only about 10 percent of the population.

Distribution of Federal Health Service Outlays, 1976

Beneficiary group	Outlays (millions)	Population (thousands)	Per capita outlays
Poor persons, total	$11, 920	24, 975	$477
Aged (65 and over)	4, 070	3, 313	1, 233
Other adults (19 to 64)	5, 949	21, 662	362
Children and youth (0 to 18)	1, 901		
Nonpoor persons, total	24, 015	187, 328	128
Aged (65 and over)	15, 828	18, 787	842
Other adults (19 to 64)	6, 407	168, 541	49
Children and youth (0 to 18)	1, 780		
Total	35, 935	212, 303	169

Source: U.S. Office of Management and Budget, *The Budget of the United States Government: Fiscal Year 1978, Special Analyses*, 1977, p. 223; U.S. Bureau of the Census, "Money Income and Poverty Status of Families and Persons in the U.S.: 1976 Advance Report," Series P-60, No. 107, pp. 3, 25. The poor/nonpoor beneficiary group distinction is based on the Bureau of the Census poverty guidelines, which provide an adjusted family income poverty cutoff point determined by the cost of a "minimally adequate diet" and other related factors, adjusted for changes in the Consumer Price Index.

Health care service tax expenditures, in contrast to health care service spending programs, result in greater per capita benefits for individuals in higher income brackets. In addition, the deduction for medical expenses is available only to taxpayers who itemize personal expenses. These taxpayers generally have relatively large incomes. Moreover, recent increases in the standard deduction have further concentrated the benefits of this tax expenditure among taxpayers with income of $20,000 or more, while precluding some middle and lower income taxpayers from receiving any health care tax expenditure benefits from this provision.

Like other tax expenditures in the form of deductions or exclusions from taxable income, individuals in higher marginal tax brackets receive larger health care tax expenditure benefits per dollar of medical expense incurred. For a taxpayer in the 50 percent marginal tax bracket who itemizes deductions, the Federal Government will match half of any unreimbursed eligible expenditures for medical care and insurance. A taxpayer in the 15-percent bracket, on the other hand, receives only a 15-percent subsidy for qualified medical expenses and health insurance premiums. Poor persons without tax liability, recipients of a significant portion of health care spending benefits, receive no tax expenditure aid for substantial medical expenses or medical insurance premiums.

The exclusion from employee taxable income of employer contributions for health insurance premiums also concentrates health care tax expenditure benefits in relatively higher income classes compared to the spending programs because only those persons currently in the labor force generally participate in employer-sponsored insurance

plans. Moreover, high-salary, full-time workers are more likely to receive health insurance benefits than are lower paid and less than full-time employees. Benefits are denied those not in the labor force, most notably the aged.

Fifty-six percent of the benefits of the exclusion of employer contributions to medical insurance premiums went to taxpayers with expanded gross income [4] exceeding $20,000 in fiscal year 1977, while the same group received 62 percent of the tax benefits of the medical expense deduction in the same year.

Administration

No conclusive studies are available regarding the administrative efficiency of health care tax expenditures relative to health care spending programs. Critics of medicare and medicaid argue that these programs are expensive to administer and unusually susceptible to fraud, abuse, and inefficiency. Since physicians are practically assured payment for services under these programs, it is argued that no incentive exists to limit expensive, unnecessary surgery or extravagant medical services and testing. In addition, they point to instances of fraud where physicians have received payments for services never performed. Critics claim that excessive administrative expenses would be required to effectively guard against such abuse and fraud.

Proponents of Federal health care spending programs reply that, in fact, the same incentives for abuse exist under all medical insurance plans, public or private, including plans subsidized by tax expenditures. And while tax expenditures undoubtedly cost the Federal Government less to administer than direct spending programs, it is argued that this is chiefly because so little "administration" of the former takes place, not because tax expenditure programs are inherently less costly to administer. Additional auditing of the medical deduction tax expenditure would be useful because, according to the Treasury Department, an IRS study of 1973 tax returns indicated that of those taxpayers deducting medical expenses, more than 75 percent claimed the wrong amount.

If the Internal Revenue Service were to audit carefully all medical deductions appearing on individual income tax returns, it presumably would incur costs comparable to those incurred in evaluating claims for reimbursement under spending programs. Moreover, spending program proponents contend that there is no reason for supposing that the costs of administering tax-subsidized private health insurance systems differ appreciably from the costs of administering a system of direct Federal reimbursement of medical expenses. Indeed, they point out that medicare and some medicaid programs are adminstered primarily by private insurance carriers under contract to the Federal Government.

Effects on Health Care Costs

Federal spending programs for health care and, to a lesser extent, the tax expenditures related to employer and employee contributions for medical insurance premiums both have contributed to the unprecedented expansion of the health care sector over the past several decades

[4] Expanded income is a somewhat broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

and the assocated increase in health care costs. Between 1960 and 1976, the Consumer Price Index increased at an average annual rate of 4.0 percent, while the medical price component increased at a rate of 5.2 percent. Health care costs increased especially quickly after 1966, the year in which medicare and medicaid began.

The medicare and medicaid programs exert pressure on health care costs by reimbursing health care providers primarily on a cost-plus, fee-for-service basis. This method of payment dampens incentives for cost-minimizing behavior by physicians and hospitals since payments are not based on Government-calculated cost estimates or rate schedules. Doctors and hospitals are free under these programs to increase prices so long as they are "reasonable" in relation to the industry as a whole.

Government-controlled medicare and medicaid service fees, however, might only reduce the willingness of providers to accept medicare or medicaid patients, since the prices for other patients would remain uncontrolled. Program costs would be limited, but the benefits to program recipients might decrease.

The impact of tax expenditures on health care costs is less direct than that of medicare and medicaid. By reducing the cost of health insurance contributions and relatively high medical care expenses, the deduction for medical care expenses may reduce consumer sensitivity to the rise in health care prices. On the other hand, because the provision is only available when these expenses exceed 3 percent of adjusted gross income, taxpayers cannot always know beforehand whether a certain medical expense or portion of health insurance premiums will be eligible for a partial government tax expenditure subsidy. This element of uncertainty lessens the probable effects of this tax expenditure on individual decisions regarding health care and their associated effects on health care costs.

The exclusion from taxable income of employer contributions for health insurance creates a powerful incentive for labor unions and other employee groups to bargain for tax-subsidized health benefit programs rather than for direct wage increases, especially when average wages are quite high. Over the past two decades, employer contributions for health insurance premiums have increased significantly, both absolutely and as a fraction of total employer and employee contributions. Most health insurance is currently purchased through employer groups.

The growth in private health insurance coverage (induced in part by the exclusion for employer health insurance contributions), together with the medicare and medicaid insurance programs, has resulted in large increases in third-party payments of health care costs. This "spreading" of cost and risk among institutional third parties may reduce the sensitivity of consumers to high and rising medical prices.

The tax deduction for contributions to nonprofit hospital construction funds and the exclusion of interest on State and municipal hospital construction bonds may indirectly contribute to the price of hospital care. Tax-exempt bonds currently finance nearly 60 percent of all hospital construction and rehabilitation,[5] while private,

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House Committee on Interstate and Foreign Commerce, *Health Planning and Resources Development Amendments of 1978*, H. Rept. No. 95-1185, 95th Cong., 2d sess., May 15, 1978, p. 70.

nonprofit hospital construction funds receive substantial Federal subsidies from the charitable contribution tax expenditure. These two tax subsidies have been important factors contributing to the growth of hospital construction over the last several decades, which has allegedly resulted in an oversupply of hospital beds in many areas of the country. The cost of maintaining this excess capacity, it is argued, is reflected in increased hospital costs.

Increases in the cost of health care have significantly affected the operation of several Federal health programs. The floor limiting the medical deduction to expenses in excess of 3 percent of adjusted gross income was originally intended to insure that this tax provision be used only for catastrophic health expenses, not for day-to-day health care costs. However, with the rise in the cost of health care, the average taxpayer, according to the Treasury Department, spends approximately 8 percent of income on medical care, and is, therefore, eligible for tax expenditure benefits, undermining the original intent of the provision.[6] In addition, increases in the cost of health care have necessitated larger copayment and deductible charges for health care insurance plans, particularly medicare.

Overlap of Benefits

Tax and direct spending health care programs are often complementary in that the tax expenditures tend to subsidize the cost of medical care and health insurance for younger, working taxpayers, while the spending programs insure many of these same persons when they reach retirement age.

There is very little overlapping of tax and direct spending health care benefits for individuals at a given point in time. Persons receiving medicare payments will not generally receive tax expenditure benefits from the exclusion of employer contributions to health insurance, nor are such persons likely to have medical expenses exceeding 3 percent of adjusted gross income that are not covered under the medicare program. Lower income individuals receiving medicaid payments have, for the most part, little or no tax liability and are, therefore, ineligible for tax expenditure benefits.

Tax expenditures overlap only in the sense that a taxpayer can qualify for more than one at the same time. Persons cannot, however, receive benefits from more than one tax expenditure for the same health care expense.

Legislative Initiatives

The Administration introduced hospital cost containment legislation in April 1977. The bill has been reported, with amendments, by two Congressional committees and is presently being considered by two other committees. In general, the Administration's proposal is intended to limit increases in hospital revenues from inpatient services on the basis of national price trends and other related factors. The Administration plan would reduce total anticipated public and private health expenditures by approximately $2 billion in fiscal year 1979, with an associated decrease in Federal health care outlays of of $730 million. In addition, the President proposed fraud and abuse

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[6] U.S. Department of the Treasury, *The President's 1978 Tax Program: Detailed Descriptions and Supporting ing Analyses of the Proposals*, Jan. 30, 1978, p. 46.

legislation intended to cut down on medicaid payment errors, with anticipated Federal outlay savings of about $300 million.

National health insurance has been discussed and debated since World War II. The Carter Administration announced a set of "guidelines" in July 1978, which it hopes will serve as the basis for specific national health insurance legislation in the future.

If a national health insurance program were enacted, tax expenditures related to individual health care expenses and private insurance plans might become superfluous, depending upon the plan's scope of coverage. However, tax expenditures related to health care institutions—the deduction for charitable contributions and the exclusion for interest on State and local hospital construction debt—would most likely remain an important component of Federal policy regarding health-related construction, education, and research.

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RETIREMENT PROGRAMS

Tax Expenditures

Tax expenditures are a major component of Federal income security policy for retired persons and their dependents and survivors. Tax expenditures have been, in particular, a primary factor contributing to the rapid growth in private institutional retirement saving over the last several decades.

Retirement tax expenditures are of three distinct types: (1) tax expenditures that lower the cost of private saving for retirement, including the exclusions from taxable income of pension contributions and earnings under employer pension plans, retirement plans for the self-employed, and other individual retirement plans, and the exclusion from taxable income of interest on life insurance savings as it accumulates; (2) tax expenditures that increase the value of Federal retirement benefits, including the exclusion from taxable income of social security retirement benefits and railroad retirement benefits; and (3) tax expenditures that directly reduce tax or taxable income for persons 65 years of age and older, including the additional personal exemption for persons 65 years of age and older, the tax credit for the elderly, and the partial exclusion of capital gains on home sales for persons 65 years of age and older.

Revenue losses resulting from retirement tax expenditures will total approximately $23 billion in fiscal year 1979, compared to direct outlays for retirement programs of approximately $113 billion. Retirement tax expenditures are discussed in greater detail on pages 137–140, 151–154, 161–166, and 171–173 of Part I in this compendium.

Spending Programs [1]

The major Federal retirement spending programs are the insurance and pension programs administered by the Social Security Administration, the Department of Defense, and the Civil Service Commission. Estimated outlays for these programs are listed in the following table.

[1] In addition to spending program benefits specifically targeted to retired persons, many low-income retired persons receive additional Federal aid from public assistance programs including medicaid, supplemental security income, food stamps, and the various HUD low-income housing assistance programs for the elderly.

Estimated Outlays for Federal Retirement Programs

[In millions of dollars]

Program	1978	1979	1980
Civilian programs:			
Social security old-age and survivors insurance	78, 801	87, 866	96, 707
Railroad retirement system	3, 830	4, 004	4, 184
Federal employee retirement systems	10, 951	12, 286	13, 744
Uniformed services programs:			
Military retirement system	8, 156	9, 001	10, 314
Coast Guard	137	155	170
Public Health Service	30	34	39
Total	101, 905	113, 346	125, 158

SOCIAL SECURITY OLD-AGE AND SURVIVORS INSURANCE

The social security old-age and survivors insurance (OASI) program currently provides a continuing source of income to more than 28 million retired workers and their dependents and survivors. The OASI program is financed by a payroll tax paid equally by employers and employees (and by a single adjusted tax for the self-employed) covering over 90 percent of the total work force. The 1978 OASI tax rate is 4.275 percent each for employers and employees (6.01 percent for the self-employed), and applies to a taxable wage base of $17,700.[2] Both the payroll tax rate and the taxable wage base will rise significantly over the next several years as a result of previously enacted legislation.

OASI benefit levels are based on a weighted average of monthly earnings subject to the social security tax, the number of dependents or survivors, and the retiree's age. Full benefits are available at age 65 and reduced benefits at age 62. Social security benefits are tax-exempt.

Monthly payments are reduced by one-half of gross annual earned income over $4,000 for retirees between 65 and 72 years of age.[3] Beneficiaries over age 72 receive full benefits regardless of earned income.[4] Passive income[5] does not affect the level of social security payments.

Monthly payments are adjusted annually in accordance with changes in the Consumer Price Index, and averaged $242 in November 1977. Total family benefits (retirees, dependents, survivors) are limited to a fixed maximum related to a worker's basic monthly benefit.

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[2] The employer/employee OASI tax rate of 4.275 percent and the 6.01 percent rate for the self-employed do not take into account the additional disability and hospital insurance taxes which together with the OASI rate comprise the total social security payroll tax. Including the taxes for retirement, disability, and hospital insurance, the total OASDHI tax rate for calendar 1978 is 6.05 percent each for employers and employees, and 8.1 percent for the self-employed.

[3] The amount of exempt earned income allowed under the social security program is scheduled to increase for those between 65 and 72 over the next several years from $4,500 in calendar 1979 to $6,000 by calendar 1982. For those between 62 and 65, the increase will be somewhat slower.

[4] The age for full benefits regardless of earnings will be reduced to 70 in 1982.

[5] Passive income is defined as all investment income, private retirement and disability payments, and all Government transfer payments such as social security and unemployment compensation.

RAILROAD RETIREMENT SYSTEM

Retired railroad workers with at least 10 years of railroad employment and their dependents and survivors receive benefit payments under the Federal railroad retirement program. Established by the Railroad Retirement Act of 1934, a year before the passage of the Social Security Act, this program was the first retirement system for private industry workers administered by the Federal Government. Program benefits are financed by a payroll tax on employees and employers equal to the social security rate, an additional payroll tax payable by employers alone, annual appropriations from general revenues, and transfers from the social security trust fund.

Under the revised Railroad Retirement Act of 1974, retired workers receive benefits calculated on a "two-tier" payment structure. The tier I payment is equal to a social security payment based upon both railroad and nonrailroad earnings, while the tier II payment is a supplemental benefit based solely on railroad employment earnings, length of employment in the railroad industry, and the place of employment (railroad or nonrailroad) before retirement. Retired workers are entitled to full benefits at age 65, or at age 60 with 30 or more years of service. Reduced benefits may be paid to workers who retire at ages 62 to 64 with less than 30 years of service. Railroad retirement payments are tax-exempt.

Railroad retirement beneficiaries are subject to strict retirement rules. Workers may not receive benefits during any month in which they work in the railroad industry or during months in which they work for their last nonrailroad employer preceding retirement, regardless of their salary. In addition, the tier I component of the railroad retirement benefit payment is subject to the same earnings test as are regular social security payments for income earned from post-retirement, nonrailroad employment.

The 1974 Railroad Retirement Act revisions generally eliminate the possibility of workers receiving benefits under both the railroad retirement and social security programs, although a grandfather clause protects persons entitled to dual payments prior to 1975. For those receiving both social security and railroad retirement benefits under this grandfather clause, the tier I component of the railroad retirement benefit is reduced by the amount of the monthly social security payment.

Tier I benefit levels are increased annually under social security cost-of-living provisions, while current law authorizes several tier II benefit increases through January 1, 1981.

FEDERAL EMPLOYEE RETIREMENT SYSTEMS

The civil service retirement system is the largest retirement program for Federal workers, covering most Congressional and executive branch employees. Smaller plans provide benefits for the Federal judiciary, foreign service officers, employees of the Tennessee Valley Authority, and most other Federal employees not covered by the social security or civil service systems.

Payments under the civil service retirement system are financed by a 7-percent deduction from employee salary (7½ percent for Congres-

sional employees), matching contributions by the respective government employer, and by an annual subsidy appropriated to the Civil Service Commission. Benefits are based on length of service and average salary for the 3 consecutive years of civilian service during which salary was highest.

Civil service retirement benefits are significantly larger, on average, than social security benefits because of more liberal benefit formulas and the absence of a maximum earnings tax base. However, the 7-percent contribution to the civil service retirement system (which also covers employees in the event of disability) is substantially higher than the current OASDI rate of only 4.95 percent. Federal employees must have served a minimum of 5 years to receive benefits, and may retire as early as age 55 with 30 years of service. There are no provisions for payments to dependents of retired employees, but qualified survivors are eligible for annuities.

Passive and/or earned income from employment not covered by the civil service retirement system does not reduce the amount of the annuity. Employee and survivor payments are adjusted twice a year based upon increases in the cost of living, as reflected in the Consumer Price Index.

Unlike social security and railroad retirement payments, which are tax-exempt, Federal retirement benefits are similar to private pensions in that payments are included in taxable income to the extent they reflect employer contributions. Employees are, however, allowed to exclude from taxable income over the life of the pension that portion of benefits that reflects their own previous contributions.[6]

UNIFORMED SERVICES PROGRAMS

The Federal Government fully funds retirement benefits for military personnel and for military members of the Coast Guard and Public Health Service through annual Congressional appropriations. In addition, military personnel were included under the social security system by the Servicemen's and Veterans' Survivors' Benefit Act of 1956. The military retirement program is described on page 206 in the section on military manpower tax expenditures and spending programs.

Relationships Between the Tax Expenditures and Spending Programs

Distribution of Benefits

Except for the tax credit for the elderly, all retirement tax expenditures are either tax deferrals or exclusions from taxable income. The value of these tax expenditures is, therefore, increased the higher the taxpayer's marginal tax bracket. Persons with no tax liability receive no benefits from these retirement tax expenditures. A direct social security payment of $200 results in a tax expenditure worth $30 to a taxpayer in the 15-percent bracket, while the same payment is worth $100 in tax expenditure benefits to a taxpayer in the 50-percent bracket, a difference of $70. Tax expenditures that operate

[6] If the employee expects to recover his entire contribution within the first 3 years of benefit payments, special rules permit all payments to be tax-exempt until the employee's contribution is recovered, after which all benefits received are fully taxed.

through tax deferrals, such as the exclusion for employer pension contributions and earnings, result in significant benefit disparities between high- and low-bracket taxpayers the longer the tax is deferred.

In contrast, Federal retirement spending program benefits are generally calculated on the basis of employment tenure and average lifetime earnings rather than on the basis of a recipient's marginal tax bracket. Although this method of determining benefits results in larger payments for employees with higher average lifetime earnings and longer work experience (and who are, therefore, generally in higher marginal tax brackets), the distribution of Federal retirement benefits across income classes is less concentrated among upper income taxpayers than the distribution of retirement tax expenditures. Moreover, retirement spending programs provide substantial benefits to lower income retirees whose lack of taxable income precludes them from receiving retirement tax expenditure benefits. Formulas used to calculate retirement spending benefits are generally weighted in favor of lower paid workers, with minimum and maximum benefit levels and taxable wage ceilings further narrowing the disparity in benefit payments between low- and high-income workers.

The following table shows the 1973 distribution of social security retirement beneficiaries by income class.

Social Security Retirement Beneficiaries, by Family Income Classes for 1973

[Thousands]

	Family head age 62 to 64	Family head age 65 and over
Family income [1]		
Less than $3,000	319. 8	6, 043. 0
$3,000 to $5,000	324. 8	3, 670. 5
$5,000 to $10,000	286. 9	3, 220. 1
$10,000 and over	230. 0	1, 488. 5
Total	1, 161. 5	14, 422. 1

[1] Family income is defined as all earned and passive income, including all Government cash transfer payments, for all family members aged 14 and over.

Source: Social Security Administration, Office of Research and Statistics.

The data in the table suggest that many retired persons who received social security retirement payments in 1973 probably received no benefits from the associated retirement tax expenditures because they lacked sufficient tax liability.[7] In calendar year 1977, a retired married couple filing a joint return with adjusted gross income of $7,200 and claiming the standard deduction would not benefit from tax expenditures associated with social security payments or any other tax-exempt retirement payments; nor would they benefit from any other tax expenditures based on credits or exclusions of income from tax.[8]

[7] Most taxpayers with family income under $3,000 and a number of those with family income between $3,000 and $5,000 had little or no tax liability. Moreover, because "family income" includes non-taxable Government payments, it is likely that many families with $5,000–$10,000 of "family income" also had no tax liability and, therefore, received no retirement tax expenditure benefits of this type.

[8] However, the additional tax exemption for persons 65 years or older, considered a retirement tax expenditure, contributes to this relatively high ($7,200) AGI level at which a retired couple first becomes eligible for the specific types of retirement tax expenditures mentioned.

Effect of Earned and Passive Income

Federal retirement payments either fall or remain constant as a beneficiary's additional earned and/or passive income increases. For instance, social security payments and a portion of railroad retirement payments are reduced when a recipient's earned income exceeds certain specified levels. Similarly, retirement payments either remain constant with additional passive income, as in the case of investment income, or are reduced, as in the case of a recipient receiving both social security and railroad retirement benefits. No retirement spending program systematically increases benefit levels with a recipient's additional earned and/or passive income.

In contrast, tax expenditures, with one exception, increase in value the greater a person's additional earned and/or passive income. For example, the value of a tax-exempt social security payment or the additional exemption for the elderly is greatly enhanced for a person with significant additional taxable income and a correspondingly high marginal tax bracket. Conversely, persons with no taxable earned or passive income, and therefore no tax liability, receive no tax expenditure benefits from the exclusions for social security and railroad retirement payments or from the additional exemption for the elderly.

The one exception to this rule is the tax credit for the elderly, which, unlike other retirement tax expenditures, decreases in value as a retired taxpayer's income rises above specified limits. The amount on which the credit is calculated is reduced by one-half of adjusted gross income in excess of $7,500 for a single person and $10,000 for a married couple filing a joint return. Thus, for single taxpayers, the credit is no longer available when adjusted gross income reaches $12,500. For an elderly couple (both 65 or older) filing a joint return, the credit is no longer available when AGI exceeds $17,500. The maximum amount of income eligible for the credit is also reduced dollar-for-dollar by any social security benefits or other tax-exempt retirement income.

The value of the tax expenditure resulting from the exclusion of employer pension contributions and earnings from taxable income depends on the marginal tax bracket of the employee at the time the contribution is made, the employee's tax bracket when the pension payment is received, and the length of time tax is deferred. The higher a taxpayer's marginal tax bracket when a contribution is made, and the longer the tax on the contribution is deferred, the greater is the value of the tax expenditure. In addition, the lower an employee's marginal tax bracket when he receives pension payments, the greater is the tax expenditure, since the employee pays a smaller portion of the accumulated contributions and earnings to the Government in taxes. Therefore, employees with significant taxable income at the time contributions are made and little taxable income when pension payments are distributed receive substantial benefits from this tax expenditure.

Treatment of Dependents

Two retirement spending programs increase the level of payments for beneficiaries with dependents. Social security recipients with eligible dependents are entitled to an additional payment equal to 50 percent of the retired worker's basic monthly benefit up to a specified maximum

family payment; railroad retirement benefits are also available to qualified spouses of insured workers.

Tax expenditure benefits, on the other hand, are generally reduced for retired persons with dependents to the extent that additional personal exemptions lower taxable income, placing the taxpayers in lower marginal tax brackets.

Relationship of Social Security Retirement System to Private Pension Plans

Employer-funded pension plans and the social security program are the two most widespread employee retirement systems. Social security is the largest spending program in the Federal budget, with estimated outlays in fiscal year 1979 of $87.9 billion. The preferential tax treatment of "qualified" employer pension plans is the second largest tax expenditure, with estimated revenue losses in fiscal year 1979 of $11.3 billion. "Integrated" private pension plans, which tie pension contributions and payments to the social security taxable wage base and benefit levels, are expressly approved under the Internal Revenue Code as plans that can receive the tax expenditure benefits available for qualified pension plans. In recent years, integrated plans have been adopted by many employers in an attempt to coordinate the two systems. However, the effects of major recent social security benefit and financing initiatives on integrated plans are uncertain.

Under an integrated private pension plan, employers are allowed to calculate private employee pension contributions and payments on the basis of existing social security benefit levels and tax rates so that the combination of private pension and social security retirement payments replace roughly the same percentage of pre-retirement wages for workers at all wage levels. However, recent social security benefit and tax rate increases may have sharply altered the nature of the increasing number of integrated private pension plans, even though no statutory changes have been enacted with respect to the tax laws governing the latter. Moreover, many experts believe that without substantial changes in the existing laws that define integration procedures, future legislated changes in the social security system may affect the financial stability of, and the continued necessity for private pension systems.

RULES GOVERNING PENSION INTEGRATION

The Revenue Act of 1942 required that for a pension plan to be qualified for favorable tax treatment, it must not discriminate in favor of officers, shareholders, or higher paid employees in the payment of benefits.[9] An exception was provided, however, for integrated plans designed to supplement social security benefits. Such plans were allowed beneficial tax treatment—even if eligibility to receive benefits was dependent to some degree upon receiving compensation in excess of the social security wage base—so long as the plan provided proportional equality of benefits at all income levels after taking into account

[9] Currently section 401(a)(4) of the Internal Revenue Code.

social security payments. That is, plans considered qualified under this nondiscrimination clause could pay proportionally greater benefits to higher paid employees above the social security wage base as compared to lower paid employees whose total wages were covered by the social security tax. Some types of integrated plans could exclude altogether employees earning less than the maximum social security earnings ceiling.[10] Current Internal Revenue Service rules for applying integration to various types of pension plans are extremely complex. The most recent comprehensive guidelines were issued in 1971 in Revenue Ruling 71–446.

EXTENT OF INTEGRATION

The number of employees covered by integrated private pension plans is difficult to determine given the existing data. The most comprehensive study on this subject, done by the Congressional Research Service, shows that integrated plans are particularly prevalent among smaller firms.[11] The study estimated that of the 412,376 pension, profit sharing, and stock bonus plans existing in 1974, 60 percent were integrated in some way with the social security system. In terms of firm size, 64 percent of the small firms with less than 26 employees were integrated compared to an integration rate of only 29 percent for larger firms with more than 26 employees. As a result, the study estimated that only between 25 and 30 percent of all pension plan participants, or 7.5 to 9 million individuals, were covered by integrated plans.

The study also reported that companies often have more than one pension plan—a nonintegrated plan for hourly workers and an integrated plan for salaried employees. In this regard, several recent surveys of large corporations show a high percentage of integrated plans. However, these plans covered only salaried employees which the previously cited study showed were frequently integrated. One survey of the 50 largest U.S. industrial corporations showed that of the 48 with pension plans for salaried employees, 43 had plans integrated in some way with the social security system.[12] Another survey of large firms showed that, on average, only 13 percent of the pension plans covering salaried employees were not integrated in some fashion.[13]

Many experts believe that the high extent of integration among the largest corporate salary plans is evidence of a trend toward increasing overall use of integrated plans. Although the large firms cited in the surveys above may not be representative of average firms because of

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[10] There are two basic types of integrated plans—excess plans and offset plans. An excess plan is generally based on compensation earned in excess of the social security taxable wage base, or in excess of some other lower stipulated dollar amount that is uniformly applied to all employees. Under a pure excess plan, workers earning below the stipulated wage level are excluded from participation in the plan. Under a "step-rate" excess plan, all of an employee's earnings are taken into account in determining benefit payments. However, a lower percentage of compensation applies to earnings below the stipulated wage level than applies to earnings above this amount.

An offset plan covers all eligible employees, but provides that the benefits otherwise payable under the plan are to be reduced (or offset) by a stated percentage of the employee's social security benefits.

[11] Raymond Schmitt, "Integration of Private Pension Plans With Social Security," in Joint Economic Committee, *Studies in Public Welfare*, Paper No. 18—*Issues in Financing Retirement Income*, Dec. 27, 1974, pp. 174–75.

[12] The Wyatt Company, *Survey of Retirement, Thrift and Profit Sharing Plans Covering Salaried Employees of the 50 Largest U.S. Industrial Companies*, July 1, 1975.

[13] Bankers Trust Company, *Study of Corporate Pension Plans*, various issues.

their greater size and financial sophistication, such firms traditionally set financial trends in the business community.[14]

DISTRIBUTION OF INTEGRATED PENSION BENEFITS

Under the social security system, employees receive no retirement benefits for earnings exceeding the social security taxable wage base. Employees with earnings above this level receive retirement benefits based only on that portion of their earnings below the taxable wage base. As a result, the percentage of an employee's total pre-retirement wages or salary covered by the social security system is lower for higher paid employees. For example, an employee covered by social security who earned $15,000 in 1978—when the social security taxable wage base was $17,700—would receive retirement benefits calculated on the basis of 100 percent of his earnings. In contrast, an employee also covered by social security with a salary of $50,000 would receive retirement benefits based on only the first $17,700 of his salary, or 35.4 percent of his total earnings.

Employers may compensate higher income employees for differences in the percentage of their pre-retirement wages covered by social security by providing them additional retirement benefits under an integrated pension plan. An integrated plan generally provides, in effect, a higher level of retirement compensation for earnings above the social security taxable wage base as compared to the social security system, which provides no compensation based on earnings above this level. As a result, the benefits of integrated pension plans tend to be concentrated among relatively higher paid employees.

The benefits of the tax expenditure excluding employer pension contributions and earnings from taxable income are, like the pension benefits themselves, concentrated among upper income taxpayers. And, like direct pension benefits, the distribution of these tax expenditure benefits is affected by the extent of pension integration.

An estimated two-thirds of all tax expenditure benefits resulting from the exclusion of employer pension contributions and earnings in fiscal year 1977 went to taxpayers with expanded gross income [15] exceeding $20,000; moreover, 17 percent went to taxpayers with expanded gross income exceeding $50,000.

Changes in social security and private pension coverage and payment levels may have altered the distribution of private pension benefits and tax expenditures over time. When enacted in 1935, old-age and survivors insurance was intended to provide a minimum income for retired persons no longer able to work. Benefit levels and wage coverage were low, and it was assumed that benefits would be supplemented by private savings, investments, and retirement plan payments in order to provide retirees with a stable and adequate level of permanent retirement income. Over 95 percent of all workers earned less than the $3,000 social security taxable wage base in 1937, the first year of contributions.

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[14] Dennis E. Logue, "How Social Security May Undermine the Private Industrial Pension System," paper prepared for the Conference on Financing Social Security, American Enterprise Institute for Public Policy Research, Oct. 27–28, 1977.

[15] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

During World War II, employers were restricted in their ability to increase current employee benefits by high excess profit taxes, income taxes, and wage controls. In addition, the average social security replacement rate (the ratio of retirement benefits to pre-retirement earnings) declined from 27 percent to 15 percent in the decade from 1940 to 1950. As a result of these factors, the pressure to expand private pension coverage as a form of deferred wages increased dramatically during this decade. Although subsequent revisions in the social security system returned replacement rates to prior levels, coverage under private pension plans nevertheless continued to grow, from 23 percent of the work force in 1950 to 44 percent by 1974.

In the last decade, increases in social security benefits have raised social security replacement rates from 30 percent of pre-retirement earnings in 1969 to 45 percent in 1977; the taxable wage base has grown from $7,800 in 1969 to $17,700 in 1978. Fifteen percent of all American workers earned more than the social security tax base in 1975.[16]

The effect of these changes on the distribution of private pension benefits and tax expenditures remains unclear. On the one hand, increased employer costs resulting from higher payroll taxes have made integrated pension plans increasingly attractive and popular as a way of reducing the cost of providing for employees' retirement, tending to increase the concentration of pension benefits in the upper income classes. Moreover, to the extent that existing integrated plans are periodically revised to reflect tax and benefit increases in the social security system, pension benefits will be further skewed toward highly paid retirees. In this regard, however, the Congressional Research Service study previously described on page 324, found that employers typically did not rapidly revise integrated plans as changes in the social security system occurred. Moreover, the distributional effects of the increasing use of integration may be offset, to a large degree, by new pension plans covering lower paid and hourly employees who previously did not participate in any private retirement system at all. In any case, no precise relationship has yet been determined between changes in the social security system and changes in the distribution of private pension benefits.

SOCIAL SECURITY AND THE FUTURE OF INTEGRATED PENSIONS

The Treasury Department has recently expressed concern over granting tax expenditure preferences for private pension plans that concentrate benefits on upper income employees, while sometimes excluding low- and middle-income employees from receiving any benefits.[17]

Some critics of the present employer funded pension plan tax expenditure have argued that if annual inflation rates remain at 5 percent or higher, an expanded social security system could better guarantee adequate financing of retirement benefits for all income classes than existing private pension plans. For example, a private pension benefit of $2,023 (the average in 1974) would be reduced to

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[16] Social Security Administration, *Social Security Bulletin: Annual Supplement, 1975*, 1977, p. 73.

[17] U.S. Department of the Treasury, *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*, Jan. 30, 1978, pp. 147–160. The Treasury Department, in its analysis of pension integration, indicated that many integrated plans are sold to employers on the assumption that such plans specifically exclude or provide relatively small benefit levels for employees earning below the social security wage base ceiling.

$1,130 in 10 years at a 6-percent inflation rate. One study estimates that instituting cost-of-living adjustments in private pension plans would increase the average costs of the plans by about 68 percent if the annual inflation rate were 6 percent.[18] Since social security is essentially a pay-as-you-go system backed by the Federal Government, critics contend that it can better guarantee adequate benefits in the context of persistent inflation.

Proponents of the present rules governing integrated private pension plans believe they are necessary to guarantee higher paid workers retirement income equal to a high percentage of their pre-retirement earnings without increasing social security payroll taxes to politically unacceptable levels. Without integration provisions, they argue, employers would have to provide lower paid workers with pension benefits worth more than 100 percent of pre-retirement pay in order to replace a high percentage of pre-retirement earnings for higher paid workers.

They also point out that, while in the past pension benefits for higher paid employees could be supplemented by unfunded retirement arrangements, such arrangements are now restricted to only a "select group of management and highly compensated employees" by the Employee Retirement Income Security Act of 1974 (ERISA). It is also argued that the increase in pension contributions that would be required in the absence of integration provisions could result in lower current wages for many lower paid workers, and an associated reduction in their pre-retirement standard of living.

However, the Treasury Department has noted in its analysis of the integration issue that these arguments assume that the purpose of retirement programs is to provide an equal percentage of former pay to all workers at all income levels. The Treasury maintains, in contrast, that it is more important for a retirement program to provide minimum benefits for lower paid workers and, moreover, that the percentage of pre-retirement earnings that are necessary to "fulfill basic needs" after retirement decreases as earnings increase. Furthermore, the Treasury argues that current integration procedures assume that social security benefits are adequate for lower paid employees, and that only higher paid employees require the additional benefits provided by an integrated private pension plan.

The Treasury also notes that although integration has been justified by some on the grounds that employers should be allowed to consider social security contributions as part of their total contribution for an employee's retirement, there is, in fact, little correlation between a particular employee's social security benefits and the amount an employer contributes on his behalf. The social security benefits of a current employee are not directly funded by the employer. Instead, benefits are paid by employer and employee contributions after the worker has retired, since the social security system is essentially funded on a pay-as-you-go basis.[19]

Investment Effects

Increases in the scope and benefit levels of both public and private retirement systems affect the level of saving and investment in the

[18] Edward H. Friend & Company, *Quarterly Newsletter, 3d Quarter*, 1976, vol. 1, No. 4, tables 2 and 3.
[19] *The President's 1978 Tax Program*, op. cit., pp. 151–52.

economy. The social security system, unlike private pensions or personal saving plans, does not operate in the aggregate as a saving/investment mechanism. Rather, in effect, the system transfers income from the working age population to retired persons. Payroll taxes paid by the employee and employer in anticipation of future retirement benefits are not saved and invested over the period during which the employee works, but are used to finance current benefits for the retired social security population. Surpluses in the social security trust fund are invested in Government securities and have little effect on private capital markets.

It is generally believed that by guaranteeing employees a source of retirement income, the social security system also somewhat reduces the incentive for individuals to save and invest additional earnings for retirement. Thus, it is argued by some economists that the social security system discourages to some extent private saving, aggregate investment, and capital formation.[20]

Private pension plans, by guaranteeing a specified level of retirement income, also reduce incentives for personal retirement saving and investment. However, in contrast to the social security system, private pension plans create large sources of private funds available for investment, and may increase aggregate private saving and investment.

If social security benefits and the taxable wage base continue to increase, the scope and importance of private pension plans may be lessened. As a result, the amount of savings available for private capital formation may decrease, and thus slow to some degree the growth in real gross national product.

Overlap of Benefits

Taxpayers who receive private pension payments in addition to tax-exempt Federal retirement benefits such as social security receive significant retirement aid from both tax expenditures and direct spending programs. Virtually all private pension recipients also receive social security retirement benefits. Moreover, because private pension recipients tend to have higher-than-average retirement incomes, they also receive relatively larger tax expenditure benefits from the exclusion of social security benefits than do persons not receiving private pension benefits. Pension recipients, in addition to receiving social security and the associated retirement tax expenditures, may also benefit from the tax expenditure deferring or excluding interest income on life insurance payments and the partial exclusion of capital gains on home sales.[21]

In contrast, only 15 percent of all nonmarried persons receiving social security retirement benefits in 1976 also received private pension benefits. Thirty percent of all married couples who received social security that year also received pensions.[22] The majority of the social

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[20] For a discussion of this problem, see Martin S. Feldstein, "Social Security, Induced Retirement, and Aggregate Capital Formation," *Journal of Political Economy*, September/October 1974, pp. 902–926.

[21] Retired persons may also receive spending program retirement benefits from more than one Federal program. The overlapping of civil service and military pensions has in recent years been a particularly visible source of controversy and debate, as has the large number of Federal civil service retirees who subsequently establish social security retirement eligibility to receive benefits intended to favor persons with low wage-earning histories.

[22] Bureau of the Census, *Current Population Survey*, March 1977.

security recipients who did not receive private pension benefits had relatively little, if any, taxable income, and therefore received fewer, if any, overlapping benefits from tax and direct spending retirement programs.

Legislative Initiatives

The President's 1978 tax program recommended tightening the rules governing integrated private pension plans. Under the President's recommendations, employers could not use pure "excess" plans (plans which pay no benefits to employees earning at or below the wage cutoff level), and the rate of benefits or contributions, whichever is applicable, on earnings in excess of the stipulated integration wage base could not exceed 1.8 times the rate on earnings below that amount. In the case of "offset" plans, the Treasury proposed that the amount of the reduction on account of social security be limited. These provisions would tend to decrease the concentration of private pension tax expenditure benefits among higher income classes. The Treasury Department has recently reconsidered its proposal, and is now suggesting a maximum 2.1 to 1.0 ratio be applicable to integrated excess plans.

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DISABILITY COMPENSATION

Tax Expenditures

Tax expenditures related to disability compensation reduce the impact of the loss of earnings caused by long-term sickness or injury. These tax expenditures include the exclusion from taxable income of the following disability benefits: social security disability payments, workers' compensation payments, sick pay,[1] black lung benefits, certain military disability pensions, and railroad retirement disability benefits. The exclusion of these payments results in over 95 percent of the revenue losses associated with disability tax expenditures. The remaining tax expenditure related to disability is the exclusion from employee income of employer contributions to disability insurance plans.[2] Disability tax expenditures are a relatively small part of Federal income maintenance efforts for disabled workers. These tax expenditures are described and analyzed in greater detail on pages 137–144, 149–150, and 157–158 in Part I of this compendium.

Spending Programs [3]

Compensation payments are the principal mechanism with which the Federal Government minimizes reductions in the normal work income of disabled individuals. The estimated Federal outlays for disability-related programs are listed in the following table.

Estimated Outlays for Disability Compensation

[In millions of dollars]

Program	1978	1979	1980
Social security disability insurance	13, 649	15, 448	17, 382
Civil service retirement disability insurance	2, 176	2, 562	3, 001
Civil service Federal employees' compensation	292	228	256
Railroad workers' disability insurance	231	242	252
Special benefits for disabled coal miners	1, 062	1, 390	1, 380
Total	17, 410	19, 870	23, 271

[1] The exclusion of sick pay was repealed by the Tax Reform Act of 1976 for all but low- and middle-income taxpayers retired on disability and permanently and totally disabled.

[2] This section does not discuss special targeted tax expenditures for the handicapped. The blind receive an additional personal exemption, and employers making structural alterations to buildings and grounds designed to remove barriers to the handicapped can deduct $25,000 of the cost of such alterations, which otherwise would have to be depreciated over their useful lives.

The exclusion from taxable income of certain military disability pensions is discussed in the section on military manpower programs on pages 205–211.

[3] Disability programs for veterans and military personnel are not discussed in this section, as they are discussed on pages 341–345 and 205–211 in the context of veterans and military manpower tax expenditures and spending programs. Disabled persons also receive significant Federal aid from the medicare and medicaid health care programs, which are discussed in detail on pages 308–310 in the section on health tax expenditures and related spending programs. Low-income disabled and blind persons are also eligible for payments under the supplemental security income (SSI) program established in 1974. Persons applying for SSI must meet the same blindness or "substantial gainful activity" tests as exist under the social security disability program, as well as an income test. Although this program provides significant benefits to needy disabled and blind individuals, it is not discussed in this section, as it is not a form of disability compensation. SSI is distinct from the rest of the programs listed in the text above in that it is financed entirely from general revenues, is income-tested, and is unrelated to previous employment and earnings. The other programs are based on an insurance compensation concept: eligibility is dependent on either having worked for a specified period of time or on having been injured while on the job, with payment levels determined to some extent on the basis of previous earnings.

SOCIAL SECURITY DISABILITY INSURANCE

Persons under the age of 65 who are insured under social security and who become permanently disabled as a result of any medically determined physical or mental impairment are eligible for social security disability payments. These payments are financed by a payroll tax paid equally by employers and employees, and are calculated as a percentage of a weighted average of pre-disability monthly earnings subject to the tax.

There are no specific provisions limiting outside earnings, although persons with substantial earned income may fail to qualify for benefits under the general eligibility rule requiring that recipients be unable to engage in "any substantial gainful activity." When disability and workers' compensation payments together exceed 80 percent of pre-disability earnings, disability payments are generally reduced so as to bring the total down to 80 percent. There are no other limits on passive income.[4] Social security disability payments are tax exempt.

CIVIL SERVICE RETIREMENT DISABILITY INSURANCE

The civil service retirement disability insurance program is the counterpart of social security disability insurance for Federal civilian employees. Also financed equally by employer and employee contributions, benefits under this program are determined by the employee's length of service and highest average salary for 3 consecutive years. Disabled employees are guaranteed a minimum benefit payment equal to 40 percent of their "high-three" salary. No limits are placed on passive income or salary earned outside the civil service system, but recipients who regain their earning capacity may have their eligibility terminated.

CIVIL SERVICE FEDERAL EMPLOYEES' COMPENSATION

The Federal Employees' Compensation Act insures Federal civilian employees against the risk of job-related injury. By comparison, the civil service retirement disability program described above compensates employees for any disability that forces early retirement, regardless of cause. Compensation for job-related injuries under the Federal employees' compensation program is payable to employees with temporary or permanent and partial or total disabilities, and is financed by general Federal revenues.

Benefits are two-thirds of the disability-induced reduction in earning power, increased to three-fourths for a recipient with dependents. Income other than earnings of partially disabled employees does not result in benefit reductions.

RAILROAD WORKERS' DISABILITY INSURANCE

Railroad workers are insured against disability under the recently revised Railroad Retirement Act. Benefits are financed by a payroll tax on employees and employers equal to the social security rate, an additional payroll tax payable by employers alone, annual appropriations from general revenue funds, and transfers from the social security trust fund. The benefit levels are based on a complex formula resulting in two primary payment components and several other supplementary payments depending upon years of service and nature of work.

[4] Passive income is defined as investment income, private retirement and disability payments, and all Government cash transfer payments such as social security, unemployment compensation, etc.

One major payment component is based on the social security benefit formulas using railroad and nonrailroad earnings. The other major component is based solely on railroad service and earnings. Employees who retire on disability after 1975 may not receive double benefits from both the social security and the railroad retirement plans. Benefits are reduced in any year in which a retiree's earnings exceed $2,500.

SPECIAL BENEFITS FOR DISABLED COAL MINERS

This program insures miners and their dependents against disability or death due to pneumoconiosis (black lung disease). Claims filed under this program before December 31, 1973 are financed through open-ended appropriations. Coal mine operators are liable for claims filed thereafter unless the Department of Labor is unable to assign operator liability or the State has not yet enacted legislation providing adequate coverage. In these cases, benefits are provided from the black lung disability trust fund, established in 1977 and financed by a tax on all coal mine operators and by advances from the Federal treasury. Basic payments under the special benefits to disabled coal miners program are 50 percent of the minimum payment to disabled GS–2 employees, with the percentage increasing with the number of dependents.

Benefits are subject to reduction when earned income of the miner or the miner's parents, brothers, or sisters exceeds specified levels. Additional disability insurance or workers' compensation payments also result in benefit reductions.

Relationships Between the Tax Expenditures and Spending Programs

Distribution of Benefits

Both the tax expenditures and the spending programs associated with disability provide benefits to persons when sickness or an accident occurs. All but one of the tax expenditures—the exclusion from employee income of employer contributions to disability insurance plans—result from the exclusion from taxable income of payments received as disability compensation or sick pay. As a result of these exclusions, the value to disabled individuals of each dollar of direct disability compensation is increased in proportion to their marginal tax rate.[5]

For example, if the taxable income of a beneficiary receiving a $1,000 disability payment is subject to a marginal tax rate of 14 percent, the value of the associated tax expenditure—the value of excluding the disability benefit from the beneficiary's taxable income—is 14 percent of $1,000, or $140. On the other hand, if the recipient is in the 50 percent bracket, the value of the exclusion is $500. Individuals without tax liability do not benefit from this tax expenditure. Thus, the larger an individual's other income (or the income of a spouse, if filing a joint return), and hence the higher the individual's marginal tax rate, the larger are the tax expenditures per dollar of direct disability benefits received.

[5] Under the Tax Reform Act of 1976, the maximum tax exclusion for sick pay is reduced dollar-for-dollar as adjusted gross income rises above $15,000. Therefore, although this tax expenditure still awards greater benefits per dollar excluded to taxpayers in the marginal brackets approaching the $15,000 maximum, the total amount of tax benefits received is phased out for those above the $15,000 level.

In contrast, many of the disability spending programs, including social security, railroad retirement, Federal employees' compensation, and the program of special benefits to coal miners, stipulate that when certain types of beneficiary income (earned, passive, or both, depending upon the program) exceed some limit, benefits are reduced. The civil service disability program holds benefits constant as other income increases. In contrast to the tax expenditures, no direct spending disability program systematically increases benefits as other income increases.

The tax expenditure that excludes employer contributions to disability insurance programs from employee income functions like a Government subsidy, reducing the cost to individuals of purchasing such insurance. Like the tax expenditures resulting from direct disability outlays, the relative value of this subsidy is larger the higher an employee's marginal tax bracket.

Disabled persons without taxable income do not benefit from the exclusion of disability payments from taxable income. The data presented in the table below, indicating the distribution of social security disability recipients by income class in 1973, suggest that a significant number of disability beneficiaries probably did not benefit from the associated tax expenditure because they lacked sufficient tax liability.[6]

In calendar year 1977, a married couple filing jointly without dependents whose combined adjusted gross income did not exceed $5,200 would have no taxable income, and therefore would not benefit from the tax expenditures excluding disability payments from taxable income. In contrast, families with expanded gross income [7] exceeding $15,000 received approximately one-third of all disability tax expenditure benefits in fiscal year 1977.

Social Security Disability Beneficiaries, by Family Income Classes for 1973

[Thousands]

	Family head less than age 62	Family head age 62 to 64 [1]
Family income: [2]		
Less than $3,000	478. 4	196. 5
$3,000 to $5,000	233. 8	108. 3
$5,000 to $10,000	341. 2	110. 1
$10,000 and over	187. 7	36. 6
Total	1, 241. 1	451. 5

[1] No category for disabled head aged 65 or more is provided because almost all of these families are retired worker and widow units receiving retirement rather than disability benefits.

[2] Family income is all earned and passive income, including any Government cash transfer payments, of all persons aged 11 and over in the family.

Source: Social Security Administration, Office of Research and Statistics.

[6] Most taxpayers with family income under $3,000 and a number with family income between $3,000 and $5,000 had little or no tax liability after taking into account personal exemptions and the standard deduction. Moreover, because "family income" includes non-taxable Government payments, it is likely that many families with $5,000–$10,000 of "family income" also had no tax liability and, therefore, received no disability tax expenditure benefits.

[7] Expanded income is a broader income concept than adjusted gross income, the standard base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

Effect of Family Size on Program Benefits

Larger families have less taxable income, due to additional exemptions and tax credits, than smaller ones with the same economic income. Consequently, larger families are generally subject to lower marginal tax rates on the same amount of economic income. Since the value of a tax expenditure that excludes certain payments from taxable income increases as marginal tax rates increase, tax expenditure benefits related to disability payments are reduced as family size increases. In contrast, the benefits of several of the disability spending programs increase with the size of the recipient's family. In no case, however, do benefit payments decrease as family size increases.

Work Disincentive Effect

The tax expenditures excluding social security disability and workers' compensation benefits from taxable income may increase the attractiveness of retiring on disability and may reduce the incentives for those already receiving disability benefits to return to work, increasing both the tax and direct costs of both these programs.

The exclusion of social security disability benefits from tax increases the percentage of after-tax earnings replaced by disability benefits (the replacement rate) for an average worker by up to 15 percentage points.[8] Since disabled workers are subject to a strict retirement test and may lose all benefits if they return to work, high replacement rates substantially affect the attractiveness of possible reemployment. For example, a 55-year-old worker with a spouse and one child and earnings of $7,681 in 1974 qualified for social security disability benefits worth 83 percent of pre-retirement gross earnings in 1975.[9] However, because benefits are exempt from tax, they are worth nearly 100 percent of after-tax net earnings, eliminating any financial incentive for the recipient to return to work at or below his previous salary. Some critics have charged that high net replacement rates—in part due to the tax expenditure—may have contributed to the 47 percent average increase in the disability retirement rate between 1968 and 1974.[10]

The exclusion of workers' compensation benefits from taxable income may similarly lead to substantial work disincentive effects for those receiving compensation and, in particular, may induce current employees to retire early on disability. In some cases, critics contend that high replacement rates and liberal definitions of disability in certain municipal service sectors have led to more rapid disability retirement by employees capable of performing less demanding jobs, thereby increasing program costs by a substantial amount.

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[8] House Committee on Ways and Means, *Report of Consultants on Actuarial and Definitional Aspects of Social Security Disability Insurance*, Committee Print, 94th Cong., 2d sess., 1976.

[9] U.S. Department of Health, Education, and Welfare, Office of the Assistant Secretary for Management and Budget, *Staff Report: Current Legislative Issues in the Social Security Disability Insurance Program*, April 1977, p. 14.

[10] Social Security Administration—Rehabilitation Services Administration Ad Hoc Committee, *Final Report: Ways To Improve the Trust Fund and SSI Programs (Rehabilitation Services)*, September 1975; *Report of Consultants on Actuarial and Definitional Aspects of Social Security Disability Insurance*, op. cit.

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UNEMPLOYMENT COMPENSATION

Tax Expenditures

Unemployment compensation benefits are excluded from taxable income. The resulting tax expenditure increases the value of Government payments to those temporarily out of work. The revenue loss associated with this tax expenditure will be an estimated $1.1 billion in fiscal year 1979, compared to $11.1 billion in expected Federal unemployment outlays. A related minor tax expenditure benefitting private supplementary unemployment insurance trusts will result in a revenue loss of approximately $10 million in fiscal year 1979. Unemployment tax expenditures are discussed in greater detail on pages 145–146 and 159–160 of Part I in this compendium.

Spending Programs

The projected Federal outlays for the unemployment insurance program for fiscal years 1978 through 1980 are listed in the following table.

Estimated Outlays for Unemployment Compensation

[In millions of dollars]

Program	1978	1979	1980
Unemployment compensation	11, 500	11, 100	10, 400

The primary purpose of the unemployment insurance program is to protect workers against wage loss during periods of unemployment. The program is geared to workers who generally have stable employment but suffer occasionally from temporary unemployment due to economic downturns or recessions. It is administered by the States, each setting its own rules for determining the level, duration, and eligibility for benefits. During particularly poor economic periods, Federal programs operate to extend the duration of benefit payments beyond the limits set by the State programs. The unemployment insurance program is financed by Federal and State payroll taxes on employers.

Relationships Between the Tax Expenditure and Spending Program [1]

Distribution of Benefits

The distribution of tax savings from the unemployment tax expenditure is weighted more heavily toward middle-income families than the distribution of unemployment compensation outlays. The distribution

[1] This section does not include a discussion of the relatively small tax expenditure relating to the use of supplemental unemployment insurance trusts, as it will result in estimated revenue losses of only $10 million annually during the next 5 years.

of direct unemployment compensation benefits and the associated tax expenditure by income classes is provided in the following table.

Percentage Distribution of Unemployment Compensation Benefits, Fiscal Year 1977

Income class (thousands) [1]	Percentage distributions	
	Tax expenditure	Spending program
0 to $10	37	51
$10 to $20	40	32
$20 to $30	15	11
$30 and over	9	6

[1] Distribution data for the spending program is by adjusted gross income class, while the tax expenditure distribution is by expanded gross income class. Expanded gross income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded gross income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income. However, significant differences between adjusted and expanded gross income generally exist only for individuals with income exceeding $50,000. Taxpayers with income below $50,000 do not generally have significant amounts of tax preference income.

Source: U.S. Department of the Treasury.

The distribution of unemployment tax expenditures favors individuals with relatively greater incomes compared to the distribution of direct unemployment compensation payments because tax expenditures are worth more the higher one's marginal tax bracket. Recipients of direct unemployment compensation payments who have high earnings in that portion of the year in which they are employed, who have non-wage income such as interest, dividends, or capital gains, or who come from a family with another wage earner tend to fall into higher marginal tax brackets and, therefore, receive greater benefits from the tax expenditure. Lower income workers receiving unemployment compensation payments benefit little or not at all from the associated tax expenditure because they often pay no taxes or are taxed at very low rates.

Stabilization Effect

Stabilization of the economy was one of the original objectives of the unemployment insurance program. The program provides income to people who are out of work, perhaps due to an economic downturn. The exclusion of benefits from taxable income supports this stabilization goal by further increasing taxpayers' disposable income during times of unemployment, but it does so in a way that may be less effective than possible alternatives.

This tax expenditure provides the greatest benefits to individuals who have the highest incomes. These people generally are more able than others to draw on other income or dip into savings to maintain their former spending levels while they are unemployed. Thus, those receiving the greatest benefits from the exclusion are least likely to have their patterns of consumption affected. In contrast, lower income workers less able to draw on savings or other income sources, whose consumption patterns are therefore more sensitive to wage replace-

ment levels, receive lower or no benefits from the exclusion. An alternative that distributed tax savings more evenly among income classes during recessionary periods would probably have a somewhat greater stabilization effect than the current unemployment tax expenditure.

Work Disincentive Effect

Unemployment compensation payments reduce the cost of unemployment by replacing lost wages. The exclusion of benefits from taxation further reduces the cost of unemployment. The lower cost of not working leads some individuals to more frequent or longer spells of unemployment. This tax expenditure, therefore, tends to increase the level of Federal unemployment compensation outlays. Furthermore, the loss in man-hours of work due to the added work disincentive of the tax expenditure reduces Federal income tax collections. However, studies of the impact of this disincentive effect on the overall level of unemployment and income tax collections show that the impact of the work disincentive is not large.[2]

The extent to which the unemployment compensation system acts as a disincentive to work depends on the percentage of a recipient's former wages that are replaced by both the direct unemployment payment and by the associated tax expenditure; the larger the percentage of wages replaced, the greater is the disincentive to work.

For families with additional outside income, tax expenditures can significantly increase the percentage of after-tax wages replaced by direct unemployment payments (the replacement ratio). In States with relatively liberal unemployment benefit levels, this increase in the replacement ratio may result in significant disincentive effects for members of families with substantial additional income.

For example, a recipient with two children living in Massachusetts (which has relatively liberal benefit payments) who normally earns $100 per week and whose spouse earns $20,000 per year receives net pay after deduction of Federal and State taxes of about $62 per week. The weekly unemployment payment is approximately $50 plus $12 in dependents' allowances, or $62, producing a net replacement ratio of 100 percent. However, in the absence of the tax expenditure, the after-tax value of the $62 unemployment payment would be about $47 for a recipient receiving benefits for 8 weeks,[3] resulting in a net replacement ratio of only approximately 76 percent. The tax expenditure increases the replacement ratio by approximately 24 percent and, in this case, very likely results in a strong work disincentive.

In contrast, a recipient with the same size family in the same State also receiving $100 in gross weekly earnings but without the additional $20,000 of family income would receive after-tax pay of about $90 and an unemployment payment of $62, producing a net replacement ratio of about 69 percent. However, the tax expenditure for this recipient is worth nothing because of the lack of tax liability, and it does not increase the replacement ratio or the work disincentive.

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[2] Gary Fields, "The Direct Labor Market Effects of the U.S. Unemployment Insurance System: A Review of Recent Evidence," Technical Analysis Paper No. 26, U.S. Department of Labor, Office of the Assistant Secretary for Policy, Evaluation, and Research, January 1975, p. 15.

[3] This estimate is based on the recipient's marginal tax rate (the percentage rate that applies to an additional dollar of earned income), and assumes the taxpayer elects the standard deduction.

Recipients of unemployment compensation who have additional family income and live in States with low benefit levels also have significantly increased wage replacement ratios as a result of the tax expenditure. However, given a relatively low initial benefit level, even a substantial increase in the net replacement ratio—say, from 25 percent to 50 percent—is unlikely to produce a strong work disincentive effect, since recipients still only receive half their former net earnings in unemployment benefits. Thus, the work disincentive effects of this tax expenditure are probably most significant for unemployment compensation recipients with additional income in States with liberal unemployment benefit levels.

Terminating the unemployment tax expenditure would eliminate the work disincentive to which it gives rise. The reduction in the work disincentive might be offset in part, however, if unemployment benefits are increased in response to the lower after-tax benefits that would result from subjecting unemployment compensation to tax. Furthermore, if financed by State revenues, increased benefit levels may lead to higher State unemployment insurance taxes.

Legislative Initiatives

The House of Representatives has passed President Carter's 1978 tax reform proposal to tax unemployment compensation benefits for middle and upper income recipients. The Administration argued that the present exclusion is improper as a matter of income definition. Moreover, the Administration noted that unemployment benefits from employer-financed programs or from general union funds are included in adjusted gross income and are, therefore, subject to tax. The House provision would include 50 cents of benefits in adjusted gross income for every dollar by which adjusted gross income plus the total amount of benefits exceeds the threshold income levels of $25,000 and $20,000 for joint and single tax returns, respectively.

Critics of the proposal, such as the AFL-CIO, argue that relatively little additional revenue would be collected by the partial inclusion of benefits in taxable income (approximately $0.3 billion in fiscal year 1980), and that such a policy would only impose greater hardship on working families already suffering from the loss of job earnings.

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VETERANS BENEFITS

Tax Expenditures

Tax expenditures supplement the Federal Government's program of veterans payments and services by increasing the value of all payments made to veterans with tax liability. Veterans tax expenditures include the exclusion from taxable income of death and disability benefits and pensions paid by the Veterans' Administration (VA) and education assistance provided under the Veterans Readjustment Benefits Act of 1966 (the GI bill). The revenue loss resulting from these tax expenditures is expected to be approximately $1.0 billion in fiscal year 1979, while outlays for veterans spending programs are expected to be $19.6 billion. Tax expenditures related to veterans benefits and services are discussed in greater detail on pages 177–178 in Part I of this compendium.

Spending Programs

One-half of the U.S. population is currently eligible for one or more of the Federal Government's veterans programs. The major Federal outlays for veterans benefits and services are listed in the following table.

Estimated Outlays for Veterans Benefits

[In millions of dollars]

Program	1978	1979	1980
Veterans death and disability compensation and pensions	9, 900	10, 700	11, 300
Veterans education and training benefits	3, 400	3, 100	2, 800
Medical care for veterans	5, 300	5, 800	6, 200
Total	18, 600	19, 600	20, 300

VETERANS DEATH AND DISABILITY COMPENSATION AND PENSIONS

The Federal Government compensates veterans for the loss of earning capacity due to service-related disability or death. Upon the service-related death of a veteran, eligible survivors (the widow, widower, children, and, in some instances, dependent parents) may elect, subject to restrictions, to receive benefits under either of two programs: the death compensation or the dependency and indemnity compensation (DIC) program. Most recipients choose the more recent DIC formulation.

The amount of benefits paid to veterans or their survivors depends on the severity of the veteran's disability (in the case of compensation paid to living veterans), his service rank (in the case of benefits paid to survivors), and the number of his dependents (in both cases).

Except for DIC payments to the parents of deceased veterans, which are subject to an income test, benefit payments are not affected by the amount of the beneficiary's other income or wealth.

The number of survivors receiving compensation as a result of a veteran's service-connected death will decrease to 364,000 during 1978, while the number of veterans receiving compensation for service-connected disabilities is expected to increase in 1978 to 2,254,000.

Pensions are intended to provide a partial means of support for needy war veterans and their eligible survivors. Veterans are eligible for pensions provided they have served a minimum term of active wartime duty, are permanently and totally disabled for reasons not caused by service, and meet certain income criteria. Needy survivors of deceased veterans are also eligible for pensions. Veterans 65 years of age and older are considered permanently and totally disabled for purposes of pension eligibility. There is no disability requirement in survivorship cases.

The size of pension benefits is based on the beneficiary's income and number of dependents, the size of the veteran's estate in survivorship cases, and his spouse's unearned income. Single veterans with net annual income after certain deductions exceeding $3,711 and veterans with dependents and net annual income of more than $5,071 are not entitled to pension payments. In survivorship cases, dependents are not entitled to pensions if the veteran's estate is large enough to provide adequate income support. Basic pension payments range up to $222 a month for veterans in the lowest income brackets with three or more dependents ($197 a month for a single veteran).

Most of a veteran's earned and passive income [1] is considered when determining pension eligibility and size, including 90 percent of any additional private pension and social security income, and in some cases the unearned income of a spouse. However, public or private relief or welfare, veterans disability compensation, and all of a spouse's earned income are excluded in determining pension size. Aggregate veterans pension benefits are therefore sensitive to changes in social security and railroad retirement benefits and other types of retirement income.

The number of veterans receiving pensions is expected to decrease by 19,000 to about 1,027,000 in 1978; the number of survivor pensions is expected to decrease by 10,000 to approximately 1,272,000 in 1978.

VETERANS EDUCATION AND TRAINING BENEFITS

The Veterans' Administration provides financial assistance for education and training to those qualified under the Veterans Readjustment Benefits Act of 1966. Referred to as the GI bill, this program also assists eligible dependents of veterans who died from service-related causes, who are permanently and totally disabled as a result of service in the armed forces, or who are prisoners of war or are listed as missing in action. Assistance is provided to ease the financial burden of attending school and to restore lost educational opportunities to veterans whose schooling was interrupted by active military duty. Benefits are available only to eligible veterans who served in the armed forces between February 1, 1955, and December 31, 1976.

[1] Passive income is all investment income, private retirement and disability payments, and all Government transfer payments, such as social security, unemployment compensation, etc.

Those entering the military after 1976 may choose to receive education assistance under a new contributory plan.

Most education assistance takes the form of regular monthly payments to the veteran or his dependents. In addition, tutorial assistance allowances, work-study allowances, and counseling services are provided. The basic monthly allowances vary according to the type of education or training sought and the number of dependents. The basic rates are unaffected by the amount of the veteran's other income or wealth.

Approximately 1,615,000 veterans are expected to receive education benefits in 1978.

MEDICAL CARE FOR VETERANS

In addition to its other services, the Veterans' Administration provides medical care for eligible veterans and their survivors and dependents. The VA operates hospitals, domiciliary and outpatient clinics, and nursing homes. It also makes payments to Federal, State, and community hospitals, nursing homes, and domiciliary clinics for veterans medical care. Those eligible also can obtain outpatient treatment from private physicians and dentists, who are reimbursed for their services by the VA.

In general, veterans with service-connected disabilities, veterans receiving VA compensation or pensions, and veterans otherwise unable to meet the cost of necessary care are eligible to receive benefits under this program. The civilian health and medical program of the Veterans' Administration (CHAMPVA) provides private hospital and outpatient care for the spouse and dependents of a veteran who has a service-related total disability or a veteran who died from service-related disabilities. VA facilities may be used by a veteran's dependents and survivors if specialized treatment is required.

Relationships Between the Tax Expenditures and Spending Programs [2]

Distribution of Benefits

Veterans programs that are not income-tested, such as death and disability compensation and the GI bill program, generally award equal benefits to veterans with the same number of dependents (and, in the case of disability compensation, the same degree of disability) regardless of their income. However, equal benefit payments to veterans in all income classes result in greater associated tax expenditures as the recipients' taxable incomes increase. A direct payment of $100 under the GI bill or disability compensation program is worth, for example, $40 in associated tax expenditure benefits to veterans in the 40 percent marginal tax bracket, but only $14 to those in the 14 percent bracket. Veterans with no taxable income receive no associated tax expenditure benefits.

Veterans that receive payments under income-tested programs, such as the veterans pension program, also receive varying degrees of tax expenditure support depending upon their marginal tax bracket.

[2] The relationship between GI bill education benefits and the related tax expenditure is discussed in the context of higher education policy on pages 273–282 of Part II in the section on higher education tax expenditures and spending programs.

Although veterans over the income eligibility limit receive neither spending nor tax benefits, those under the limit receive greater tax expenditure benefits for each dollar of direct payment as their marginal tax bracket increases. However, the tax expenditure associated with the veterans pension program is relatively small because of the program's income eligibility limitations, resulting in estimated revenue losses of only $40 million annually in fiscal years 1978–81.

Relation of Benefit Payments to Age and Family Size

Several veterans programs provide increased benefits to veterans with dependents. In addition, veterans pensions are increased by 25 percent for recipients age 78 and over. In contrast, veterans tax expenditures are decreased for elderly recipients and those with dependents to the extent that additional tax deductions and exemptions put them in lower marginal tax brackets.

Efficiency

Veterans pensions are intended to provide partial financial support to elderly and disabled war veterans and their survivors on the basis of financial need. Pension benefits are limited, therefore, to veterans with so-called "countable" annual income below certain specified levels—currently $3,711 for a single veteran or widow and $5,071 for a veteran or widow with one or more dependents. Moreover, benefit levels are increased in relation to a veteran's "need" as defined by countable income; a single veteran with no countable income currently receives a monthly pension payment of $197, while a veteran with $3,000 of annual countable income receives only $15 per month.

However, because the definition of countable income used in determining pension eligibility and benefit levels currently excludes several significant income sources—including all of a spouse's earned income and 10 percent of all social security payments—veterans with significant amounts of excluded income continue to receive direct pension payments and significant related tax expenditures, somewhat undermining the needs-based intent of the program.

Veterans without tax liability, many of whom are most in need of financial aid, receive no tax expenditure benefits from pension payments. For example, while the Veterans' Administration reported that 73 percent of those receiving pensions in 1977 had countable income under $3,000, and virtually all recipients had countable income below the $4,760 eligibility limit in effect at the time, the Treasury Department estimated that, in the same year, nearly half of all veterans tax expenditures resulting from the exclusion of pension payments went to those with expanded income [3] exceeding $5,000. Tax expenditures thus appear to reduce the effectiveness of the veterans pension system by providing greater tax benefits in most instances to those less in need of financial assistance.

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[3] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income. However, significant differences between expanded and adjusted gross income distributions generally exist only for taxpayers with income above $50,000. Taxpayers with income below $50,000 do not generally have significant amounts of tax preference income.

Legislative Initiatives

The House passed legislation in June 1978 that would significantly alter the veterans pension system. The revisions would, in effect, guarantee eligible veterans a minimum annual pension income, calculated on the basis of age, dependency status, and health, which would be offset dollar-for-dollar by the annual income of the veteran, his spouse, and dependent children. Income from virtually all sources, including all social security payments and all earned income of the veteran and his dependent spouse, would be counted in determining pension payments. Benefits under the legislation would be substantially increased above their present levels. In addition, benefits would be adjusted simultaneously with, and in the same percentage as, social security cost-of-living increases.

The Senate passed a similar pension revision bill in July 1978. The Senate version contains stricter income eligibility requirements than does the House bill, and also authorizes a partial exclusion of earned income in determining eligibility and benefit levels. The Senate bill would increase pension benefits by a lesser amount than the House bill.

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GENERAL PURPOSE FISCAL ASSISTANCE

Tax Expenditures

Tax expenditures are a major source of general purpose fiscal assistance for States and localities. The primary general purpose fiscal assistance tax expenditure is the exclusion from taxable income of interest on State and local debt. This provision enables States and localities to issue bonds at interest rates below those of taxable bonds. The Federal Government, in effect, pays the difference in interest costs, providing a subsidy to States and localities.

The other general purpose fiscal assistance tax expenditures are the deductions for nonbusiness State and local taxes, including real and personal property taxes, income taxes, and sales taxes.[1] In theory, these deductions reduce the impact of State and local taxes, allowing jurisdictions to maintain present tax levels more easily or to levy new or increased taxes. However, for reasons developed below in explaining the distribution of benefits to jurisdictions, the benefits of these tax expenditures go primarily to individuals in the form of reduced tax liability, rather than to State and local government treasuries. Thus, while these tax expenditures provide general purpose fiscal assistance in theory, in practice they provide States and localities with very little Federal financial aid.

The tax expenditure exempting interest on State and local debt will result in an estimated revenue loss of $6.0 billion in fiscal year 1979. The deductions for nonbusiness State and local taxes will reduce Federal revenues by an estimated $14.6 billion in fiscal year 1979. Federal outlays for general purpose fiscal assistance spending programs, by comparison, are expected to be approximately $9.5 billion in fiscal year 1979. General purpose fiscal assistance tax expenditures are described in detail on pages 181–188 in Part I of this compendium.

Spending Programs

The major Federal outlays providing general purpose fiscal assistance are the direct cash payments made to State and local governments under the general revenue sharing program. In addition, antirecession fiscal assistance payments and grants to States and localities for local public works projects were authorized in 1976 as part of the economic

[1] The deduction for property taxes on owner-occupied homes is also considered a homeownership tax expenditure, and is described and analyzed from this perspective on pages 247–254 in Part II of this compendium. Although the property tax deduction is, from the point of view of the individual taxpayer, a housing subsidy, it is included in the discussion of general purpose fiscal assistance because property taxes are a major source of general revenue for local governments. Indeed, any Federal tax deduction associated with State and local taxes can be considered a general purpose fiscal assistance provision to the extent it increases the ease with which governments can levy such taxes.

The tax credit for corporations doing business in U.S. possessions is also a general purpose fiscal assistance tax expenditure. This provision encourages business investment and economic growth, primarily in Puerto Rico (which is defined as a possession for the purpose of the provision), by allowing a credit against U.S. tax on business and qualified investment income from these possessions. The Treasury Department recently re-estimated the revenue loss in fiscal year 1979 from this provision to be approximately $700 million. However, the comparison of general purpose fiscal assistance programs is limited in this section to those that provide aid to State and local governments generally and, therefore, does not include this narrowly targeted tax expenditure, nor direct assistance programs specifically intended to aid U.S. possessions.

recovery policy prompted by the 1974–75 recession. These two economic stimulus programs will continue to generate significant outlays in fiscal year 1979. Outlays for the major general purpose fiscal assistance spending programs are listed in the following table.

Estimated Outlays for General Purpose Fiscal Assistance

[In millions of dollars]

Program	1978	1979	1980
General revenue sharing	6, 833	6, 860	6, 872
Antirecession fiscal assistance	1, 374	740	—
Local public works	2, 800	1, 920	620
Total	11, 007	9, 520	7, 492

GENERAL REVENUE SHARING

Established in 1972 and extended in 1976, general revenue sharing remains the only Federal program of direct grants to States and localities that are almost without restrictions on use. The only restrictions on projects financed by shared revenues are that they not discriminate against any group in hiring or purchasing and that they pay "prevailing wages" as defined in the Davis-Bacon Act.

Revenue sharing funds are apportioned by formula successively at the State and local level, with two-thirds of the States' allocations required to go to local governments. Revenue sharing funds are distributed among States according to a complex formula based on general population, urban population, per capita income, income tax revenue, and tax effort (the ratio of tax revenue to tax base).

State revenue sharing allotments are increased for higher income tax revenues, larger general and urban populations, and greater tax effort; allotments are reduced the higher a State's per capita income. Within States, jurisdictions entitled to at least $200 of shared revenues must receive at least 20 percent of the State per capita level of shared revenue but not more than 145 percent of that amount. Revenue sharing is authorized and funds are appropriated on a 5-year rather than a permanent basis.[2]

ANTIRECESSION FISCAL ASSISTANCE

Title II of the Public Works Employment Act of 1976 authorizes additional revenue sharing payments during periods of economic downturn to States and localities experiencing high unemployment. Funds are intended to allow State and local governments to maintain existing basic government services in danger of reduction or termination due to budgetary pressures, to reduce State and local budget cuts which tend to counteract Federal efforts to stimulate the economy, and to help stabilize existing employment levels.

Funds become available when the national unemployment rate exceeds 6 percent, with additional funds released for each one-tenth percentage point increase above that level; jurisdictions must have an unemployment rate exceeding 4.5 percent to qualify for aid. Payments

[2] For a more extensive discussion of the revenue sharing formula, see Richard P. Nathan, et al., *Monitoring Revenue Sharing*, The Brookings Institution, Washington, D.C., 1975, pp. 37–43.

are based on the relative size of a jurisdiction's general revenue sharing receipts and on the extent to which its unemployment rate exceeds the 4.5 percent minimum.

LOCAL PUBLIC WORKS

The local public works program, a major component of the Government's 1976 economic stimulus efforts, allocates funds for accelerated capital construction projects to States and localities that experience unusually high unemployment. It is administered by the Economic Development Administration, which reviews applications on a rapid basis, accepting only those projects for which on-site labor can begin within 3 months of approval. Local public works funds have been allocated to State and local governments in two separate rounds of evaluation and consideration so far.

Under round I of the program, 70 percent of the funds were allocated for projects submitted by State or local governments with unemployment rates exceeding the national average (7.78 percent in the 3-month period during 1976 used for allocation purposes). The remaining 30 percent were allocated to State and local governments with unemployment rates below the national average, with priority given to those jurisdictions with unemployment rates exceeding 6.5 percent.

Under round II, approximately 65 percent of the funds were allocated to States on the basis of their share of unemployed persons in all States. The remaining 35 percent were allocated to States on the basis of their relative unemployment rates. State shares of local public works funds were then allocated to cities and counties according to the same 65/35 percent formula.

All projects financed by the $6 billion appropriated and allocated so far are expected to be finished by 1981. Local public works projects are required to purchase 10 percent of all goods and services from minority-owned businesses.

Relationships Between the Tax Expenditures and Spending Programs

Rationale

Several tax expenditures and spending programs considered in this section were created or are continued for reasons other than general purpose fiscal assistance. Indeed, the deduction for State income taxes is allowed primarily to avoid excessive tax burdens when combined with Federal income taxes. The deduction for property taxes paid on owner-occupied homes is viewed primarily as an incentive to homeownership rather than as a method of providing fiscal assistance to States and localities.

The deductions for nonbusiness sales and personal property taxes are justified as necessary to maintain Federal neutrality with respect to the choice of sales, property, or income taxes for revenue-raising purposes on the State and local levels. These nonbusiness tax deductions are also justified on the grounds that persons with the same income after accounting for State and local tax payments should pay the same amount of Federal tax to insure the horizontal equity of the income tax system. If these were not deductible, persons with the

same income after accounting for State and local tax payments would be subject to different Federal tax rates, depending upon the State and local jurisdiction in which they lived.

The antirecession fiscal assistance and local public works programs were two of the principal components of the Government's 1976 economic stimulus policy. Although they are intended primarily to foster economic recovery, both allocate funds on the basis of population and/or tax effort criteria similar to those used for the general revenue sharing program, as well as on the basis of more explicit economic and employment-related factors.

In contrast to the antirecession assistance programs and the deductions for nonbusiness State and local taxes, general revenue sharing and the exclusion of interest on State and local debt are justified principally on the grounds of general purpose fiscal assistance. The original exclusion of State and local bond interest was apparently based, however, on the belief that the Federal Government could not constitutionally tax such interest, although it is now generally believed that Federal taxation of State interest payments would be constitutional.

Distribution of Benefits

INDIVIDUAL AND CORPORATE BENEFICIARIES

The direct benefits of the exclusion from taxable income of interest on State and local debt go primarily to high-income individuals, banks, and insurance companies. One reason for the concentration of these individual income tax benefits among higher income individuals is that tax-exempt State and local bonds are attractive investments only for persons in relatively high marginal tax brackets (usually over 30 percent). Individuals in lower tax brackets can generally receive higher net profits from taxable, interest-bearing investments, which pay a higher rate of return. As a result, they do not normally purchase tax-exempt bonds. In addition, as an exclusion from taxable income, the value of this tax expenditure increases the higher the individual's marginal tax bracket.

Because tax-exempt bonds pay lower rates of interest than alternative taxable investments, there is no incentive for tax-exempt organizations such as pension funds to purchase such securities. Commercial banks held about 50 percent of all State and local tax-exempt bond debt in 1976, reducing their average corporate income tax rate by about 19 percentage points.

Taxpayers with expanded gross income [3] exceeding $30,000 received 94 percent of the individual tax expenditure benefits from the exclusion of interest on State and local debt in fiscal year 1977, while over one-third of the individual benefits went to the approximately 50,000 taxpayers with expanded income exceeding $200,000.

The deductions for nonbusiness State and local taxes directly benefit only those individual taxpayers who itemize their personal deductions, currently about one-quarter of all taxpayers. Nearly all individuals who itemize are homeowners and, as a result, they benefit from the deduction for owner-occupied property taxes as well as from all other State and local sales, personal property, and income tax deductions.

[3] Expanded income is a broader income concept than adjusted gross income, the base used on tax returns to calculate tax liability. In addition to adjusted gross income, expanded income contains the untaxed part of capital gains, percentage depletion in excess of cost depletion, and other tax preferences subject to the minimum tax, but excludes the deduction of investment interest up to the amount of investment income.

Few individuals itemize rather than take the standard deduction solely on the basis of the deductions for State and local income, sales, and personal property taxes and other personal expenses such as medical care or child care. Homeownership and the associated mortgage interest and property tax deductions are, for the great majority of taxpayers, a prerequisite to itemizing. The tax expenditure benefits associated with these tax deductions are therefore concentrated among middle and upper income homeowners. Approximately 3 out of every 5 homeowners itemize their personal deductions.

Benefits from the deduction for nonbusiness State and local taxes are concentrated among slightly higher income individuals compared to the property tax deduction, since the value of the former tax expenditure depends not only on the recipient's marginal tax bracket, but to a large degree on the size of State income tax payments, which increase with taxable income. On the other hand, the size of the owner-occupied property tax deduction depends upon the size of property tax payments, which are determined on the basis of local property assessment rates and home value rather than personal income.

For example, in fiscal year 1977, 85 percent of the tax expenditure benefits of the deduction for nonbusiness State and local taxes (other than real estate and gasoline) went to those with expanded income exceeding $20,000, while 79 percent of the benefits of the property tax deduction went to this group. Thirty-nine percent of the benefits of nonbusiness State and local tax deductions (other than real estate and gasoline) went to taxpayers with expanded income exceeding $50,000, while only 26 percent of the benefits of the property tax deduction went to this same group.

The distribution of this group of tax expenditure benefits is also affected by differences in State and local income, sales, and property tax rates. For example, residents of Massachusetts, a State with a relatively high income tax, are more likely to itemize and receive tax expenditure benefits than residents of Texas, which has no State income tax. However, extreme variations of this type are not that common, with most States and localities emphasizing one or another of the various sales, income, or property taxes available to them, all of which are deductible.

In contrast to fiscal assistance tax expenditures, fiscal assistance spending programs provide no benefits directly to individuals or taxable corporations. Instead, all funds go directly to State and local governments.

STATE AND LOCAL GOVERNMENT BENEFICIARIES

The exclusion of interest on State and local debt enables jurisdictions to issue bonds at lower interest rates than those required for taxable bonds, thereby reducing the cost of raising funds through debt financing. The magnitude and distribution of this Federal subsidy depends on the number of tax-exempt bonds issued, the maturity period of the bonds, and the interest rate differential between the tax-exempt bonds and taxable bonds of comparable quality.

Tax-exempt bonds with relatively short maturity periods tend to carry lower interest rates relative to taxable bonds of comparable quality and maturity periods than do long-term tax-exempt bonds. Under mid-1978 market conditions, securities with maturity periods of 5 years or less sold at interest rates roughly 40 percent below taxable

rates, while 20- to 30-year securities sold at rates roughly 25 percent below taxable rates. Thus, jurisdictions that issue short-term bonds receive, on average, a larger Federal subsidy than jurisdictions that issue long-term debt.[4]

In addition, the interest rate (and the associated subsidy value) of tax-exempt bonds depends to a large degree on the fluctuations of the tax-exempt bond market. Since commercial banks and casualty insurance companies are the principal institutional buyers, the magnitude of fiscal assistance provided States and localities by tax-exempt bonds is affected by such factors as bank investment patterns and the financial situation of insurance companies, rather than solely by the financial rating of the particular jurisdiction issuing the bond.

The pattern of bond issues among jurisdictions has, over time, followed general economic and population growth trends in the United States. Jurisdictions in areas of high economic and population growth, with the greatest demand for capital funds, have traditionally issued the bulk of tax-exempt bonds. The older and larger industrial cities of the Northeast and Midwest have cumulatively issued the bulk of outstanding bond debt and, therefore, receive the most tax expenditure benefits. However, the rapidly growing jurisdictions of the South and Southwest are responsible for an increasingly large portion of the bonds issued during the last several years.

Antirecession assistance programs distribute aid to jurisdictions experiencing the greatest relative financial stress, as measured by either the jurisdiction's unemployment rate or its share of total unemployment. Financially healthy jurisdictions, which issue a significant portion of the new tax-exempt bond debt each year, receive a relatively smaller percentage of total antirecession fiscal assistance and local public works program aid because of their relatively moderate unemployment levels.

The general revenue sharing program provides cash benefits to nearly all jurisdictions, depending on their tax effort, tax rate, population, and per capita income. The program tends to equalize the fiscal capacities of rich and poor States, measured by per capita personal income. Thus, low fiscal capacity governments (those with low per capita income) receive greater per capita revenue sharing payments than do areas with high fiscal capacity. General revenue sharing also provides far more financial aid on a per capita basis to central areas of major cities than to more affluent suburban neighbors. However, the equalizing tendency of the revenue sharing allocation formula is limited, to some extent, by the per capita ceiling that limits the amount of revenue sharing funds a city may receive to 145 percent of its State's per capita allotment. As a result of this ceiling, certain large cities receive less than they would under the revenue sharing formula in the absence of such a ceiling. St. Louis, Baltimore, and Philadelphia are examples of cities limited by these ceilings.[5]

In contrast to revenue sharing, which benefits all jurisdictions, the deductions for nonbusiness State and local taxes provide little, if any, significant fiscal assistance to these jurisdictions. Rather,

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[4] U.S. Department of the Treasury, *The President's 1978 Tax Program: Detailed Descriptions and Supporting Analyses of the Proposals*, Jan. 30, 1978, p. 217.

[5] Richard P. Nathan, et al., *Revenue Sharing: The Second Round*, The Brookings Institution, Washington, D.C., 1977, pp. 134–43.

they simply act, in most instances, as Federal tax rate reductions for those taxpayers who itemize. State and local treasuries benefit from these deductions only when resistance to taxes is reduced, allowing jurisdictions to raise (or not lower) taxes. This effect is likely to be minimal in all but the most wealthy communities, since on the average only a quarter of all taxpayers itemize their tax return deductions. Except in exceptionally wealthy communities where most residents itemize their deductions for Federal tax purposes, the majority of a jurisdiction's citizens bear the same State and local tax burden regardless of whether or not such taxes are deductible.

Types of Projects Supported

Most State and local tax-exempt debt is incurred to finance capital projects such as schools, sewers, and transportation facilities, as shown by the table on the following page. As a consequence, the tax expenditure exempting the interest on State and local debt subsidizes the costs to jurisdictions of financing such capital projects. Federal spending under the local public works program exclusively supports capital projects.

In contrast, antirecession fiscal assistance funds must be used to finance current Government services. Federal disbursements for general revenue sharing may be used for almost any purpose, although, in practice, the bulk of the funds allotted on the State level has supported education, while funds distributed to localities have primarily supported police, fire, and transportation services.

State and Municipal Bonds Sold by Purposes, 1967–76

[Percent]

Purpose	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976
School	31	29	28	28	21	23	21	22	15	15
Water and sewer	14	12	12	13	15	13	10	9	8	10
Highway, bridge, and tunnel	8	10	14	8	11	9	6	4	4	5
Gas and electric	(1)	(1)	(1)	(1)	(1)	(1)	7	7	7	13
Hospital	(1)	(1)	(1)	(1)	(1)	(1)	(1)	6	7	8
Industrial	9	10	(2)	(2)	1	2	1	2	2	1
Pollution control [3]	(1)	(1)	(1)	(1)	(1)	(1)	9	10	9	8
Public housing authority	3	3	3	1	4	4	5	2	(2)	(2)
Veterans aid	1	1	1	1	1	1	2	3	3	2
Other	34	35	42	49	44	48	39	35	45	38
Total	100	100	100	100	100	100	100	100	100	100
Total (in millions)	$14,288	$16,374	$11,460	$17,762	$24,370	$22,941	$22,953	$22,824	$29,326	$33,844

[1] Percentage of bonds sold for this purpose included in "other" category.
[2] Less than 0.5 percent.
[3] Includes industrial and nonindustrial financing.

Source: The Bond Buyer

Efficiency

The tax exemption for State and local bond interest, the principal general purpose fiscal assistance tax expenditure, is generally less efficient in providing Federal funds directly to State and local governments than is the general revenue sharing program, the principal fiscal assistance spending program. The aid provided by this tax expenditure depends in part on the interest differential between tax-exempt and taxable securities of comparable quality. The narrower the gap, the less aid jurisdictions receive in terms of lower interest costs and the greater the benefits for bond purchasers in terms of greater tax savings on a higher interest return.

The efficiency of tax-exempt bonds in providing aid to State and local governments is, therefore, influenced by cyclical fluctuations in the bond market. One recent study estimated that, given money market conditions over the last several years, $1 of revenue loss from this tax expenditure results in an average Federal interest subsidy of only 70 to 75 cents.[6] The difference is "captured" by upper income individuals and institutional purchasers of tax-exempt bonds.

The general revenue sharing program, in sharp contrast, transfers essentially all funds other than those necessary for administration directly to the intended jurisdictions. The costs of administering the general revenue sharing program are relatively low, accounting for less than 1 percent of total revenue sharing outlays.

To the extent that the deductions for nonbusiness State and local taxes are viewed as fiscal assistance tax expenditures, they are generally ineffective in providing aid to State and local governments. Taxpayers who itemize are the only direct beneficiaries of these deductions. While some benefits may be transferred to State and local governments through higher State and local taxes (as proponents of the fiscal assistance argument contend), the degree to which this occurs is probably minimal, as indicated above, because of the low percentage of taxpayers who itemize personal deductions.

The antirecession fiscal assistance program is a relatively efficient way of providing cash payments to State and local governments. The administrative costs of the program, like those for general revenue sharing, are relatively insignificant. The local public works program is less efficient than other spending programs in providing funds directly to jurisdictions. Significant administrative costs are incurred in evaluating the large number of project proposals in relation to State and jurisdictional allocations, and the evaluation process often takes a considerable period of time. The Economic Development Administration approved 2,063 separate projects during the first round of fund allocations, with 23,000 applications left over for second round consideration and evaluation.

Effect on State and Local Taxes

General revenue sharing and the deductions for State and local taxes may influence the composition and incidence of State and local tax systems. The deductions for State and local property, sales, and income taxes increase the regressivity of these taxes (or decreases their progressivity, as the case may be) by reducing their burden on

[6] George F. Break and Joseph A. Pechman, *Federal Tax Reform: The Impossible Dream?* The Brookings Institution, Washington, D.C., 1975, p. 54.

high-income taxpayers who itemize. These tax expenditures may also encourage legislatures to favor taxes deductible for Federal purposes over alternative sources of revenue, particularly user taxes. General revenue sharing may also discourage State and local legislatures from imposing user charges, since receipts from such taxes are not included in the determination of tax effort used to calculate a jurisdiction's level of revenue sharing payments.

Administration

The size and distribution of general purpose fiscal assistance tax expenditure aid is uncontrolled, while direct spending programs for fiscal assistance are under relatively close Congressional scrutiny. Local public works grants are made by the EDA on the basis of Congressionally established standards. Areas suffering from high unemployment are given preference, and the total amount of grants cannot exceed Congressional appropriations. The amount of general revenue sharing funds is also limited by Congressional appropriations, with the distribution determined according to a complex formula reflecting explicit Congressional decisions about State and local needs.

The assistance provided by tax expenditures, on the other hand, is determined without periodic Federal reauthorization, review, or direction. The cost and distribution of fiscal assistance tax expenditure benefits could be controlled by the Federal Government only by amending existing tax laws. With respect to tax-exempt debt, budgetary constraints exist only in the willingness of local voters to incur obligations requiring repayment through tax revenues, a jurisdiction's ability to float bonds, and the cyclical fluctuations in the primary and secondary bond markets.

State and Local Control Over Funds

Although State and local governments have a relatively free hand in spending fiscal assistance funds, spending programs have certain limited restrictions on the use of funds not present in tax expenditure programs, which are subject to no restrictions. States and localities may not use general revenue sharing funds to finance discriminatory activities or projects that do not pay "prevailing wages" as defined by the Davis-Bacon Act. The local public works program requires that the projects it funds buy 10 percent of their goods and services from minority-owned firms. In addition, round II of the local public works program requires that special employment preference be given to the disabled and Vietnam veterans on funded projects.

Overlap of Benefits

All States issue tax-exempt bonds and receive general revenue sharing payments, resulting in overlapping tax and direct spending general purpose fiscal assistance. The amount of revenue sharing funds allocated to States does not take into account financial aid received in the form of indirect tax subsidies provided by tax-exempt bonds. Virtually all large cities issue tax-exempt bonds and receive substantial revenue sharing payments. These same cities, as well as

States, also receive direct antirecession fiscal assistance and local public works funds if they meet program qualifications.

Some degree of trade-off within communities may exist between tax and direct spending fiscal assistance benefits. To the extent that local public works and general revenue sharing funds reduce the necessity for a jurisdiction to incur debt for capital construction projects, increased appropriations for these spending programs may reduce the level of benefits flowing to a community from the exclusion of interest on State and local debt.

Since direct spending fiscal assistance funds go directly to State and local governments, individuals do not receive overlapping tax and direct benefits. However, most taxpayers who purchase tax-exempt bonds also itemize personal expenses, including State and local taxes, thereby receiving substantial benefits from both of the general purpose fiscal assistance tax expenditures.

Legislative Initiatives

The Administration's 1978 tax program recommended the repeal of the deductions for nonbusiness State and local sales and personal property taxes. Since a large percentage of these taxes is paid by individuals who do not itemize their deductions, the Administration argued that the existing provision allowing deductibility from taxable income is not a major factor for State and local governments in determining their tax rates, and only results in an inequitable distribution of the tax burden between those who itemize and those who use the standard deduction.

The recommendation was rejected by the House Ways and Means Committee in its consideration of the Administration's tax program. Committee members indicated that since some States depend more heavily on sales and personal property taxes than others, the elimination of the deduction would be discriminatory, favoring those States that depend more heavily on income taxes for revenues. In addition, some committee members believed that elimination of the deductions would unnecessarily increase the tax burdens of middle-income families.

In April 1976, the House Ways and Means Committee favorably reported a bill allowing State and local governments the option to issue taxable as well as tax-exempt bonds. However, the bill was never voted on by the House. The taxable bond option also was included in the Administration's 1978 tax proposals. Under this latest proposal, State and local governments electing the taxable bond option would receive a Federal subsidy equal to 35 percent of the interest cost of taxable securities in fiscal years 1979 and 1980 and 40 percent of the interest cost of such bonds thereafter. The taxable bond option would open to municipal borrowers large institutional sources of new credit, such as pension funds, which currently have no incentive to invest in tax-exempt bonds as a result of their already tax-exempt status.

Many State and local finance officials oppose the taxable bond option for fear it would eventually lead to the elimination of tax-exempt bonds. Other critics of the taxable option argue that it would necessitate unnecessary, and, perhaps unconstitutional, Federal interference in State affairs.

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